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# Banking Regulation

**Contributing Editor**
Bob Penn
Allen & Overy

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# INTRODUCTION

***Contributed by:** Bob Penn, **Allen & Overy***

2020 has been an unprecedented year in many respects. For financial market participants, the legacy of the COVID-19 crisis will far outweigh and outlive the disruptions of Brexit and the US election (and the re-regulation that is likely to follow each). Whereas a financial crisis spawned an economic crisis 12 years ago, this time the process is being reversed – the economic repercussions of the COVID-19 crisis will almost inevitably precipitate a financial crisis.

### A Job Well Done, but Just Begun

It is safe to say that, to date, the economic fallout of the COVID-19 crisis has been managed highly successfully by governments in most developed nations. The widespread lockdowns to stanch the spread of the disease have posed unprecedented strains on the liquidity of real economy actors, and begun to create (or exacerbate) solvency issues for businesses and individuals. Liquidity constraints have been met by unprecedented public sector support – which has served as a palliative to the immediate crisis, but also resulted in massive increases in sovereign debt. Regulators have also taken a "carrot and stick" approach to ensure banks continue lending – by requiring payment holidays (and in the case of the UK regulator, requesting that banks not enforce covenant breaches – the "stick"), but also by measures discouraging writedowns or increases to capital requirements for COVID-affected exposures (the "carrot"). There have also been welcome deferrals of regulatory reform across many developed jurisdictions.

To date, banks' responses have largely met the needs of regulators: starting from stronger balance sheets than in 2009, and largely cushioned from the immediate effects by the guidance, banks have in any event had little incentive to enforce defaulting loans in light of the practical difficulties of doing so. As we emerge into the next phase of the crisis, that position is expected to change. The pandemic's effects are starting to show on the balance sheet of the banking sector, and on that of the sovereigns to which they are tied; new prudential and conduct challenges will emerge; and banks' incentives will change.

### Building the Infrastructure to Restructure

The immediate catalyst for the change will be the beginning of withdrawal of government support: governments cannot go on borrowing to support closed businesses and fund furloughed staff forever. Many businesses will simply have run out of money in lockdown; still more will do so as economic activity fails to rebuild to pre-crisis levels. In 2021 and beyond, a wave of corporate failures and personal bankruptcy will emerge. Banks will need to prepare to deal with the wave at scale, whilst maintaining appropriate controls to ensure the fair treatment of their customers.

### Potential Barriers to, and Regulatory Conflicts in, Restructuring

Regulators will expect firms to have learnt the lessons of past foreclosure and restructuring scandals. Furthermore, in a post-COVID environment, the exercise of lenders' rights against real economy participants – particularly individuals and SMEs – will be highly politically sensitive. That sensitivity is likely to make itself felt through continued barriers to the enforcement of lenders' rights – be they legislative, regulatory (moratoria, and also conduct-derived impediments to rapid workouts), or reputational.

In this environment, reconciling banks' prudential and conduct obligations will become increasingly challenging. Prudential regulation is "selfish", in that it prioritises the safety and soundness of individual banks, while conduct regulation is "altruistic", in that it looks to the interests of clients. We currently have the rather strange (from a regulatory perspective) phenomenon of Pollyanna-ish prudential regulators leaning on banks to keep lending to support clients (and society), notwithstanding risks to their own financial health. This will need to change; the key question is when. One of the lessons from the last crisis was that banks which took early decisive action to deal with balance sheet distress fared better than those that did not: if the right balance of interests is not struck, then the banking system will be jeopardised. Banks will need to seek to ensure that such balance is struck through regulatory liaison.

### Recognition of Impairments: You Can't Fool All of the People All of the Time

The removal of government support will also trigger changes to banks' assessment of credit risk. A variety of measures have been taken to mitigate the immediate effects of the crisis on banks' balance sheets. Accounting and regulatory forbearance does not change the underlying realities of stress, however, and banks will feel the scrutiny of investors and rating agencies, which will want to understand banks' assessments of impairments and will view regulatory ratios with greater scepticism. Depending on the depth of the crisis, the palliatives delivered by accounting and prudential changes may strain the credibility of banks' disclosures: sophisticated investors and counterparties may look past regulatory ratios to other, more credible measures. Banks will need to consider their disclosure more carefully than ever.

### Debt to Equity: Who Takes the Equity?

The withdrawal of government support will also affect the inevitable reappraisal of banks' capital positions, as they confront the deterioration in the credit of non-defaulting borrowers. Support measures will typically have resulted in significant increases in borrowers' leverage: combined with a more difficult trading environment, this will leave survivors in a more precarious financial position. Restructurings, in which the banking sector will play a key role, will be needed in order to return many businesses to a sustainable financial model. It is not clear that bank regulation currently provides all the right incentives in this respect, however. In particular, the regulatory framework penalises equity holdings by banks: for example, in the EU, banks' material holdings of equity are deductible from capital under the so-called "qualifying holdings" rules, and recent changes to the Basel framework have increased the capital costs to banks of holding shares. This may prove a barrier to banks being part of the solution, meaning that structural solutions ("bad banks", asset management vehicles or the like) are needed.

### The Re-emergence of the Doom Loop

The price tag for the pandemic has thus far been paid largely by sovereigns. In the longer term, banks (particularly EU banks) are at risk from the re-emergence of the bank-sovereign doom loop that caused stress in various Southern European Member States. There is little that banks can do to manage this risk, but it will need to be factored into planning for the medium term.

### Learning to Live with the New Normal

Outside the prudential sphere, changes to working patterns look unlikely to unwind in the near future. The migration to a more flexible working structure brings with it diverse challenges for banks – particularly around oversight and market conduct. Regulators will expect firms to identify, manage and monitor the risks associated with remote working. Banks are likely to need to rely on technology to replicate the oversight generated by physical proximity, which brings with it privacy and data protection issues to work through.

Bank regulation becomes political in a crisis. Looking forward, 2021 will hopefully see the beginning of the end of the health crisis, and the resumption of some semblance of business as usual. It will take longer for the financial consequences to work through: we anticipate further deferrals of bank regulatory reform to permit the financial sector to absorb and accommodate those consequences, but also a more interventionist approach by regulators to ensure that banks continue to support recovery in national economies.

*Contributed by: Bob Penn, Allen & Overy*

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## Contributing Editor

**Bob Penn** advises banks, asset managers, market infrastructure providers and other financial institutions on a wide range of national and international regulations. He has led substantial work on the European financial services reform agenda, including advising on revisions to capital requirements, the introduction of benchmark regulation and the abolition of IBORs, the introduction of recovery and resolution plans and retail ring-fencing for banks and on changes to derivatives markets. Bob has considerable experience of running major regulatory-driven projects for clients, including ring-fencing and recovery and resolution planning. He sits on the IIF Special Committee on Effective Regulation and the BBA High Level Group on Financial Stability.


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# ANDORRA

## Law and Practice


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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

The financial industry of the Principality of Andorra (Andorra) has historically been one of the contributors to the domestic economy. In turn, the banking sector is the cornerstone of the Andorran financial system, which represents roughly 20% of the Andorran Gross Domestic Product (according to the most recent data published by the Andorran Banking Association).

Due to the country's proximity with neighbouring European countries, along with the signature of the Monetary Agreement in 2011 between Andorra and the EU, the Andorran legal framework is aligned with EU legal initiatives in terms of banking regulation, namely solvency, capital requirements, supervision, investor protection and anti-money laundering and terrorist financing.

The most relevant Andorran regulations governing the banking sector are as follows:

- Law 35/2010 on the legal regime for authorising the creation of new operating entities within the Andorran financial system, dated 3 June 2010;
- Law 7/2013 on the legal regime of the entities operating within the Andorran financial system and other provisions regulating the exercise of financial activities in the Principality of Andorra, dated 9 May 2013;
- Law 8/2013 on the organisational requirements and the operational conditions of entities operating within the financial system, investor protection, market abuse and contractual netting arrangements, dated 9 May 2013;
- Law 10/2008 regulating Andorran collective investment undertakings, dated 12 June 2008;
- Law 10/2013 of the Andorran Financial Authority (AFA), dated 23 May 2013;
- Law 8/2015 on urgent measures to introduce mechanisms for the recovery and resolution of banking entities, dated 2 April 2015;
- the Memorandum of Understanding (MoU) signed between Andorra and Spain on 4 April 2011;
- Law 20/2018 of 13 September, regulating the Andorran Guarantee Deposit Fund and Andorran Investment Guarantee System (FAGADI Law);
- Law regulating the disciplinary regime of the financial system, dated 27 November 1997 (Disciplinary Law);
- Law 35/2018, on solvency, liquidity and prudential supervision of banking entities and investment firms, dated 20 December 2018;
- Decree approving the accounting framework for entities and collective investment undertakings created under Andorran law operating in the Andorran financial system, dated 22 December 2016;
- Law 14/2017, on the prevention and fight against money or securities laundering and terrorism financing, dated 22 June 2017 (AML Law);
- Regulation for the development of Law 14/2017, 22 June, on the prevention and fight against money or securities laundering and terrorism financing, dated 6 June 2019 (AML Regulation);
- Law 20/2014, regulating electronic contracting and operators which develop their economic activity in a digital space, dated 16 October 2014;
- Law 13/2013, which regulates effective competition and consumer protection, dated 13 June 2013;
- Decree regulating the cessation of payments and insolvency, dated 4 October 1969 (Insolvency Law);
- Law 9/2005, which regulates the Andorran Criminal Code, dated 21 February 2005;
- Law 15/2003 on the protection of personal data, dated 18 December 2003 – note that Regulation (EU) No 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data (GDPR) could have an impact on the transfer of personal data carried out from Andorra due to its extraterritorial scope of application;
- Law 10/2012 on Foreign Investments, dated 21 June 2012 (Law on Foreign Investments);
- Law 19/2016, on International Automatic Exchange of Information in Tax Matters, dated 30 November 2016 (Tax Information Exchange Law); and
- Law 8/2018 on payment and electronic money services, dated 17 May.

The Andorran regulatory and supervisory authorities for the banking sector are as follows.

- The AFA is the regulatory and supervisory authority of the Andorran financial system, and its powers include issuing technical communications and recommendations in order to develop regulations and standards regarding the exercise of banking, financial and insurance activities. The AFA may also adopt the applicable fall-back of international standards for interpretational and prudential supervision purposes. On 17 September 2013, the AFA was accepted as a new ordinary member of the International Organization of Securities Commissions (IOSCO).
- The Andorran Financial Intelligence Unit (UIFAND) is an independent body created to promote and co-ordinate measures to prevent money laundering and terrorist financing. The UIFAND follows the recommendations of the European Council's MONEYVAL Committee and the 40

recommendations from the Financial Action Task Force (FATF).
- The State Agency for the Resolution of Banking Institutions (AREB) is a public institution created by Law 8/2015, and is responsible for managing the processes for the winding-up and resolution of banking entities. In turn, the Andorran Fund for the Resolution of Banking Institutions (FAREB) was created for the purpose of financing the measures adopted by the AREB in the application of Law 8/2015.
- The Andorran Data Protection Agency (APDA), created by Law 15/2003, is a public and independent institution responsible for compliance with the treatment of personal information provided by individuals, private entities and Andorra's public administration.
- Although not a regulatory authority, the Association of Andorran Banks (ABA) represents the collective interests of all Andorran banking entities. The activity carried out by the ABA is relevant for the banking sector, to the extent that it provides information for its members and the public in general, proposes appropriate recommendations and promotes co-operation among its members.

Lastly, it is also relevant to point out the self-regulation activity carried out historically by banking entities. Likewise, those Andorran banking entities which are, in turn, parent companies of consolidated groups also apply international standards on a self-regulation basis.

## 2. Authorisation

### 2.1 Licences and Application Process

Prior authorisation from the AFA is required in order to provide banking activities in Andorra.

Pursuant to Law 7/2013, Andorran banking entities are authorised to render the following financial services:

- deposit-taking, which includes taking deposits and other repayable funds (it must only be rendered by Andorran banking entities);
- granting loans and credits, including consumer credit, mortgage, factoring, with or without recourse, and forfaiting;
- financial leasing and non-financial renting with the option to buy or not;
- the granting of guarantees;
- payment transactions;
- the issuance of means of payment, including credit cards, traveller's checks and bank cheques;
- transactions for own account or on behalf of clients (on money market instruments, exchange markets, foreign exchange and securities);
- the issuance of securities and the provision of related services;
- intermediation in interbank markets;
- commercial reporting; and
- the hiring of security boxes.

Banking entities are also authorised to render the following investment and ancillary services:

- the reception and transmission of orders in relation to one or more financial instruments;
- the execution of clients' orders;
- trading for own account;
- discretionary portfolio management;
- providing investment advice;
- the underwriting of either the issuance or placement of financial instruments;
- the placement of financial instruments on the basis of a firm commitment or otherwise;
- the management of multilateral trading facilities;
- the custody and safekeeping of financial instruments on behalf of clients;
- the granting of credit or loans to an investor to enable him or her to carry out a transaction in one or more financial instruments;
- advising companies on capital structure, strategy and related issues, and providing advice and services on mergers and acquisitions of companies;
- foreign exchange services related to the provision of investment services;
- investment research; and
- services related to underwriting the issue or placing of financial instruments.

The authorisation process for setting up a banking entity in Andorra is governed by Law 35/2010. The submission form must be addressed to the AFA, along with the following documentation:

- the specific features of the banking entity's activity (ie, draft bylaws, the basic programme of activities, a specific statement on the foreseeable activities related to the promotion of the economy at a country level and a specific statement on the prospective provision of activities related to the sponsorship and patronage of educational and cultural activities in Andorra);
- the identification of the shareholders (if they are legal persons, information on the governing bodies must be provided, along with the annual financial statements and audit reports for the last three years, an affidavit on the contributions made by the shareholders to comply with the requirements established by the legislation on anti-money

laundering and terrorism financing, the curriculum vitae of shareholders and the members of the governing bodies, and a code of conduct);
- the banking entity's structural, technical and economic forecast (ie, a description of the technical means, organisational and human resources, a detailed description of the activities that are intended to be undertaken within Andorra and those that are to be outsourced abroad, a generic description of the measures that are planned to be implemented to ensure adequate internal control of the procedures, the location of the premises and forecasts regarding the establishment of subsidiaries, branches and offices, the recruitment forecasts for staff during the first three years, indicating qualification levels, balance sheets and P&L for the first three years); and
- evidence of having constituted a deposit of EUR3 million to the AFA. Note that this amount shall be returned to the applicant within 20 working days of the rejection of the application or, if authorised, within 20 working days from the start of the business activity.

Upon submitting this documentation, the AFA has a maximum of six months to notify its decision.

According to the Technical Communication 1/19 issued by the AFA, the submission fee for setting up a banking entity in Andorra is EUR30,995, and the annual supervision fee shall vary according to the banking entity's balance sheet, with a maximum fee of EUR211,470.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

Changes in the shareholding of a banking entity are subject to the prior authorisation and later registration by the AFA, when these changes imply the following:

- that any of the shareholders obtains or acquires a qualified participation;
- regardless of the relevant participation, that any of the shareholders obtains representation on the management body of the entity;
- that any of the shareholders increases the qualified participation to the extent that the percentage of voting rights or share capital is equal to or greater than 20%, 30% or 50%; or
- by virtue of the acquisition, that the entity may be controlled or become a subsidiary.

Qualified shareholding (*participació qualificada*) means any participation that, directly or indirectly, represents 10% or more of the share capital or voting rights of the banking entity. A shareholding is also deemed to be qualified if, without reaching the aforementioned percentage, it allows significant influence to be exercised over the entity. It is presumed that a natural or legal person can exercise a significant influence when, among other things, it has the power to appoint or remove a member of the board of directors.

There are no specific restrictions on foreign ownership applicable to banking entities.

# 4. Supervision

## 4.1 Corporate Governance Requirements

Pursuant to Law 8/2013, banking entities must have robust corporate governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks they are or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management. Notwithstanding this, the aforementioned arrangements, processes and mechanisms shall be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the entity's activities.

Accordingly, the board of directors of Andorran banking entities is obliged to define its risk appetite and approve the relevant risk management policies and periodically monitor its compliance, and to adopt adequate internal policies and procedures.

As far as organisational requirements are concerned, Andorran banking entities must implement a compliance function, a risk-management function and an internal audit department.

The compliance function is in charge of the supervision, monitoring and verification of the effective compliance of legal provisions and professional standards by employees and financial agents, in order to protect clients and minimise compliance risk. Moreover, in order to guarantee that the compliance function works appropriately, the entities must ensure that they have adequate authority and both technical and human resources, and must appoint a person in charge of the compliance function, in addition to avoiding participating economically in the services or activities which they are controlling.

The risk-management function carries out the following activities:

- advising senior management on the management risk policies and the determination of the level of risk tolerance;
- introducing, applying and maintaining management risk procedures; and
- monitoring the measures adopted to reduce or mitigate risk exposure.

The internal audit function is entitled to prepare, on an annual basis, a report establishing its opinion regarding the efficiency and design of the internal control and the risk management systems of the entity. This report is addressed to the management body for its review. A copy of this report must also be addressed to the AFA within the first semester following the closing of the exercise.

Law 8/2013 also establishes as a general principle that banking entities shall take all necessary measures in order to detect and prevent any conflict of interest that may arise during the performance of activities by any employee, director or assistant, which may cause any prejudice to clients.

Additionally, according to the proportionality principle, banking entities may have the following committees: audit committee; risk committee; appointments committee; and remuneration committee.

The committees must be composed of members who do not perform executive functions, and chairmen must be independent directors.

Law 8/2013 also provides for the possibility of combining the audit and risk committees and the appointments and remuneration committees, according to the proportionality principle and upon the AFA's authorisation.

Additionally, banking entities must develop adequate procedures to the extent that employees can notify possible infringements internally (ie, whistle-blowing channels). These procedures must guarantee the confidentiality of both the reporting person and the offender.

Technical communication 163/05, issued by the AFA, highlights some rules on ethics and professional behaviour applicable to Andorran banking entities, namely the prohibition on carrying out own-account operations under identical or better conditions than those of clients to the latter's detriment, and on providing incentives and compensation to clients with relevant influence on the entity.

The Andorran Banking Association published a Code of Conducts in 2017 that reflects the minimum professional standards and recommendations for the banking sector.

## 4.2 Registration and Oversight of Senior Management

Law 7/2013 sets a limit on the number of directorships that may be held by a member of the management body in a banking entity, taking into account individual circumstances and the nature, scale and complexity of the entity's activities.

In this vein, banking entities may not hold more than one of the following combinations of directorships at the same time: (i) one executive directorship with two non-executive directorships; and (ii) four non-executive directorships.

Moreover, the board members must be persons of recognised commercial and professional honour, and must also possess adequate knowledge and experience in order to exercise their duties.

The requirements of honour, adequate knowledge and experience must also be met by the managing directors, and by those responsible for internal control functions (ie, those in charge of the compliance function, the risk-management function and the internal audit department, as stated in **4.1 Corporate Governance Requirements**).

Prior authorisation by the AFA and subsequent registration is required for every appointment and replacement of directors and those responsible for the internal control functions.

Likewise, banking entities must periodically assess, at least once a year, the continued suitability of their board of directors and of each of its members, as well as of the relevant committees.

## 4.3 Remuneration Requirements

Remuneration requirements applicable to Andorran banking entities are aligned with European provisions and the guidelines on sound remuneration policies issued by the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA).

Pursuant to Law 8/2013, banking entities at the group level, parent companies and subsidiaries, including subsidiaries established in third countries (with the exception of foreign subsidiaries located in jurisdictions considered by the AFA to be equivalent for regulatory and supervisory purposes), are obliged to comply with the remuneration requirements set forth in the applicable laws, regulations and technical communications issued by the AFA.

The principles that are applicable to remuneration policies are as follows:

- the remuneration policy should be compatible with a prudent risk management and long-term business strategy;
- the remuneration policy must be compatible with the business strategy and long-term interests of the banking entity, including measures to avoid conflicts of interest;
- the board of directors must adopt and periodically monitor the general principles of the remuneration policy;
- an internal and independent assessment of the implementation of the policy must be carried out at least once a year;
- staff performing control functions must be independent and must have the necessary authority and be remunerated irrespective of the results of the business departments they monitor;
- the remuneration of the general management or those responsible for the risk management and compliance functions should be directly supervised by the remuneration committee or, if this committee is not created, by the board of directors; and
- a clear distinction should be made between fixed and variable remuneration criteria.

In this line, Law 8/2013 also establishes the following ratios between the fixed and variable components of total remuneration:

- the variable component shall not exceed 100% of the fixed component of the total remuneration for each individual; and
- financial entities may allow shareholders to approve a higher maximum level of the ratio between the fixed and variable components of remuneration, provided the overall level of the variable component does not exceed 200% of the fixed component of the total remuneration for each individual.

Andorran banking entities must follow the inspiring principles when implementing the remuneration policy, including salaries and discretionary retirement benefits for categories of staff including senior management, employees who take risks, those who exercise internal control functions, and any employee who receives a lump-sum payment that includes him/her in the same scale of remuneration as senior management and other risk-taking employees.

Law 8/2013 also establishes that infringements of these provisions may be sanctioned according to the Disciplinary Law.

# 5. AML/KYC

## 5.1 AML and CTF Requirements

Andorra is totally committed to complying with international standards on anti-money laundering and terrorism financing through the implementation of the Fourth Anti-Money Laundering Directive and the Financial Action Task Force's recommendations.

In this vein, both the European provisions and the Financial Action Task Force's recommendations are intended to serve as the backbone of the Andorran system for the prevention of money laundering and terrorism financing.

In turn, the UIFAND is entitled to draw up and publish annual reports and statistics to assess the effectiveness of the Andorran system for the prevention of money laundering and terrorism financing. Additionally, Andorra is periodically subject to the assessments of the Council of Europe, carried out by the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval).

Banking entities must comply with the following obligations:

- prior to the commencement of the business relationship, the entity must solicit the information regarding both the client (and the beneficial owner) and the transaction in order to identify them;
- the banking entity must report to the UIFAND any suspicious transaction that could involve money laundering or terrorism financing;
- information about the identity of the issuer of the suspicious reporting must be kept confidential;
- simplified and enhanced due diligence measures must be applied according to the risk profile of the client, the business relationship, the product or the transaction;
- a clients' admission policy must be drawn up;
- documentation must be kept for at least ten years;
- adequate procedures must be adopted by which to detect unusual or suspicious transactions, with the possibility of submitting a suspicious transaction report to the UIFAND;
- AML-CFT training programmes addressed to employees must be drawn up; and
- an independent external audit must be conducted to verify compliance with AML-CFT provisions, with a copy of the report sent to the UIFAND.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

FAGADI Law regulates the guarantee system for deposits aligned with Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes. It also states that FAGADI administers the scheme, as well as the relevant limits.

The key regulatory features of the deposit guarantee system are as follows:

- if the insolvency of an Andorran banking entity should occur, the clients' deposits would be repaid up to EUR100,000, and additional coverages are foreseen in exceptional cases that guarantee – up to a limit of EUR300,000 – deposits from real estate transactions of a residential and private nature, payments received by the depositor on a one-off basis and linked to marriage, divorce, retirement, dismissal, disability or death, and those that are based on the payment of insurance benefits or compensation for damages and are the result of a crime or a legal error, provided that these balances have been paid to the covered accounts during the three previous months;
- the FAGADI's ex ante resources must reach 0.8% of guaranteed deposits by 30 June 2024, through the bank's annual contributions;
- the FAGADI will receive the available finance through contributions that its members carry out at least once a year;
- if the FAGADI's available financial resources are not sufficient to reimburse depositors in cases of coverage, the FAGADI board of directors may solicit extraordinary contributions from member entities – these contributions may not exceed 0.5% of their guaranteed deposits per calendar year; and
- the FAGADI board of directors, with prior consent from the AFA, may request higher contributions in exceptional circumstances that in no case imply exceeding the maximum limit of coverage established by the FAGADI Law.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

The Andorran Criminal Law regulates the breach of professional secrecy, whereby a professional discloses or reveals the secrets of an individual, as a criminal offence punishable by imprisonment of three months to three years and disqualification for the position for up to six years.

Bank secrecy is no longer applicable within Andorra due to the adoption of the international requirements on exchange of information on tax purposes recommended by the OECD.

Thereupon, three types of exchange of information on tax purposes are regulated in Andorra: (i) the exchange of information on request; (ii) the automatic exchange of information; and (iii) the spontaneous exchange of information.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

Law 35/2018 is aligned with both Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, and requires banking entities to have minimum internal capital that, having regard to the risks to which they are or may be exposed, is adequate in quantity, quality and distribution. Accordingly, Andorran banking entities must develop strategies and processes for assessing and maintaining the adequacy of their internal capital.

The amount of capital maintained by banking entities is subdivided as follows:

- Common Equity Tier 1 capital, intended to ensure business continuity;
- Additional Tier 1 capital; and
- Tier 2 capital, intended to cover losses in the event of a liquidation scenario.

As far as the minimum capital requirements are concerned, the total amount of capital required to be held by banking entities must be at least 8% of their risk-weighted assets. The part corresponding to the highest quality capital – Common Equity Tier 1 capital – must represent 4.5% of the risk-weighted assets and 6% the part corresponding to Tier 1 capital.

Law 35/2018 also introduces the obligation to cover 100% of liquidity outflows net of liquidity inflows with high liquidity assets, within 30 days and in a stress scenario, such as a major withdrawal of deposits.

Other obligations include the inclusion of intra-day operations in the supervision regime, the obligation to develop methodologies to manage the positions of financing, the distinction between pledged assets and unencumbered assets, and the adoption of liquidity recovery plans.

Regarding structural long-term liquidity ratio or stable funding, Andorran provisions require banking entities to cover their long-term liabilities (ie, longer than 12 months) through a variety of stable funding instruments, under both normal and stress conditions. On a quarterly basis and in a single currency, they must also report to the AFA the elements that require stable financing.

Law 35/2018 also includes the obligation to publish the so-called solvency report, which must include the following information:

- data on the financial situation and activity of the banking entity;
- market strategy;
- risk control;
- internal organisation and corporate governance; and
- compliance with the minimum equity requirements laid down in the solvency regulations.

Likewise, banking entities must have policies and processes in place for the identification, management and monitoring of the risk of excessive leverage.

These indicators include the leverage ratio, which is the amount of Tier 1 capital of the entity divided into the total exposure value of the entity, expressed as a percentage. To this extent, the obliged entity shall address the risk of excessive leverage in a precautionary manner by taking due account of potential increases in the risk of excessive leverage caused by reductions of the entity's own funds through expected or realised losses, depending on the applicable accounting rules. Additionally, entities must submit information on the leverage ratio to the AFA, which must monitor the levels of leverage in order to reduce the risk of excessive leverage.

In addition to other own fund requirements, banking entities must hold 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. The countercyclical capital buffer should be built up when aggregate growth in credit and other asset classes with a significant impact on the risk profile of such banking entities are judged to be associated with a build-up of system-wide risk, and drawn down during stressed periods.

Note also that Andorran banking entities have implemented IFRS standards with the Decree approving the accounting framework for entities and collective investment undertakings created under Andorran law operating in the Andorran financial system, dated 22 December 2016, which requires entities operating in the Andorran financial system and Andorran collective investment undertakings to prepare their individual and consolidated annual accounts in accordance with the international financial reporting standards adopted by the European Union (IFRS-EU).

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

Law 8/2015 establishes a framework for the recovery and resolution of Andorran banking entities, and also regulates the legal status of the resolution authority, namely AREB.

This piece of law establishes that a banking entity is under a restructuring situation when it breaches or could breach the applicable liquidity and solvency regulations in the near future, but it is able to comply again with that regulations by its own means.

In such a situation, the bank must give notice to the AFA in order for it to adopt ex officio measures such as a formal requirement to the bank's management body to draft an action plan to redress the situation, the appointment of a special administrator, or the removal of one or more members of the management body, among others.

If the banking entity cannot redress its stressed situation, the AREB shall assess whether it has to initiate its resolution process.

The resolution process of a banking entity requires the fulfilment of the following requirements:

- that it is not financially viable;
- that it is reasonably unexpected that it could be redressed by measures from private stakeholders; and
- that there are reasons of public interest.

Law 8/2015 entitles the AREB to apply a set catalogue of resolution tools (*instruments de resolució*) and to intervene in a banking entity to ensure continuity in its critical financial and economic functions, while minimising the impact of the banking entity's failure on the Andorran economy and national financial system, and minimising the total resolution costs for taxpayers.

The resolution measures established by Law 8/2015 encompass the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool (ie, including the exercise of write down and conversion powers).

The bail-in tool does not apply to claims insofar as they are secured, collateralised or otherwise guaranteed. Certain kinds of unsecured liability are excluded from the bail-in tool, as covered deposits.

Note that a draft bill amending Law 8/2015 is in the process of being ratified. Overall, the most relevant amendments are as follows:

- the subjective scope of application is extended to investment firms and other financial institutions (with the exclusion of insurance companies);
- two new regulatory requirements are regulated:
  (a) the draw-up of recovery plans; and
  (b) the calculation of the MREL ratio, as an additional and complementary requirement to capital, liquidity and leverage ratios; and
- a separation of situations involving early temporary measures by the AFA from the resolution phase by the AREB (ie, to this extent the resolution phase is divided into the preventative phase and the execution phase).

## 10. Horizon Scanning

### 10.1 Regulatory Developments

Andorran banking entities are continuously monitoring the most up-to-date significant developments in banking regulation.

According to the Monetary Agreement, the implementation of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MiFID II) and Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR) is planned by 2020-2021.

Andorra recently joined the International Monetary Fund. Andorra's General Council (*Consell General*) passed a law on 5 October 2020 that specifically points out the commitments and appointments that Andorra has to undertake for its effective adherence into this organisation.

In addition, Andorra is currently negotiating the Association Agreement with the EU.

To this extent, Andorran banking entities face a twofold challenge: (i) the regulatory challenge; and (ii) technological innovation and digital transformation.

Regarding the latest challenge, the Andorran Banking Association has drawn up a report that compiles the main indicators on the digital transformation that Andorran banking entities are undergoing. According to this report, within the last five years, the Andorran banking sector has invested more than EUR120 million in digital projects in order to modify the entities' technological architecture, to improve the digital transformation of communication channels and to develop electronic banking, among others.

As a consequence, the banking industry is facing a substantive transformation of its activity because of the need to renew the provision of its services in the interest of investors and society at large.

**Cases & Lacambra** is the leading business law firm in the Principality of Andorra. It has a marked international character and focuses on the client, aiming to offer the best comprehensive business law advice to local and international players. The firm has a solid, recognised and highly tested track record in both national and cross-border banking matters, and in the regulation of financial markets, corporate and debt transactions, special situations and asset recovery. It has also had a respected tax practice since 2016. The team is made up of highly qualified professionals, who have very marked methodologies and are orientated to satisfy the needs of the most demanding international institutional and private clients.

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CASES & LACAMBRA

# Trends and Developments

***Contributed by:***
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### Challenges Facing the Andorran Banking Industry

The economic openness of the Principality of Andorra has unlocked unprecedented levels of growth and development within recent decades. The Andorran legal framework has been enriched exponentially by the signature of the Monetary Agreement with the EU, and presents a level playing field comparable with the most advanced jurisdictions; on the other hand, the Monetary Agreement has posed significant challenges to the local banking sector within a short period of time.

Along with existing regulations based on European standards and already implemented into local law according to the Monetary Agreement, the regulatory avalanche scheduled for 2020 and 2021 is likely to be very challenging for Andorran banking entities, namely the adoption of:

- Directive 2014/65 on markets in financial instruments (MiFID II);
- Directive 2018/843 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AML 5); and
- Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR).

The following two recent milestones should also be noted:

- the negotiation of the "Association Agreement" with the EU, being the current key area under discussion related to the freedom of goods (the conclusion of the negotiations with the EU is expected in two years); and
- the accession to the International Monetary Fund in October 2020 in order to gain access to a lender of last resource, to the extent that there is no Central Bank in Andorra and banking entities have traditionally used foreign correspondents for all kinds of assets.

The Association Agreement will be key for the development of the Andorran banking sector. On the one hand, it will determine whether Andorra is capable of establishing a reciprocal passport (or soft passport) regime with EU jurisdictions for the rendering of banking and financial activities, enabling foreign banks to operate locally and vice versa. On the other hand, how the freedom of movement of persons is negotiated will determine whether exit taxes will apply in home countries to new residents. If these two obstacles are overcome, private banking activities in the jurisdiction are likely to receive a boost.

The regulatory pressure combined with the supervisory activity carried out by the Andorran Financial Authority (AFA), mainly as a result of the new IFRS accounting standard and both the capital and solvency requirements, may slow down the R&D initiatives of banking entities due to the associated economic and human costs.

Notwithstanding this, the Andorran government is actively promoting the use of innovative and disruptive technological tools (digital identity, distributed ledger technologies and artificial intelligence), focusing mainly on digitalisation in both the public sphere and the private sector. To this extent, in July 2020 the Andorran government announced the so-called "Horitzó 23", a plan adapted to the new scenario emerging from the COVID-19 pandemic, in order to promote Andorra as "a resilient, sustainable and global country". The plan includes a total of 77 actions divided into 20 initiatives framed in three pillars: welfare and social cohesion, economy, and innovation. Some of the legislative initiatives included in this plan are related to the enhancement of e-commerce business, the boosting of digital transformation and the modernisation of the public administration.

Likewise, Andorran public institutions are working on a large-scale transformation of the Andorran economy to attract new investments, predominantly orientated towards fashionable niche markets such as fintech, esports and start-ups that develop distributed ledger technologies. However, this transformation should come with an enhancement of the process of setting up an Andorran company, the deadline for which may be extended for some months (ie, including the foreign investment authorisation).

In this emerging scenario, Andorran banking entities may benefit from these new business opportunities, in terms of cost reduction strategies and collaboration agreements entered into with these new players.

The COVID-19 outbreak has also triggered a considerable effort for the Andorran economy, notably for small and medium-sized enterprises. The exceptional measures adopted by the Andorran government (ie, financial support) and the proactive approach of the banking sector (ie, promoting telecommuting) are contributing towards mitigating the negative impact of the pandemic on the economy and society at large.

The Act of exceptional and urgent measures for the health situation caused by the pandemic SARS-CoV-2 (the Omnibus Act) was approved by the General Council on 23 March 2020. The main target of the Omnibus Act was to mitigate the first effects of the health crisis on people and companies in Andorra, according to the principles of solidarity and co-responsibility. The Omnibus Act was based on a temporary situation and the COVID-19 outbreak continued beyond April 2020, so a second range of economic measures was approved pursuant to Act 5/2020, of 5 April (the Omnibus Act II). The relevant measures were related to employment and social security questions, along with tax and administrative deadlines. However, the most relevant measure adopted was the approval by the Andorran government of a special package of soft loans (*crèdit tous*). The soft loans were guaranteed with an interest rate of between 0.1% and 0.25% fully assumed by the Andorran government and channelled through the Andorran banking entities, up to a maximum amount of EUR130 million, intended to finance companies and business. The Andorran government then approved a second package of EUR100 million on 20 May. Within the second wave of COVID-19, new restrictive measures were adopted (the catering and leisure sectors were the most affected) along with an additional package of financial assistance, while avoiding a mandatory lockdown of the Andorran population.

Under this scenario of significant instability and high volatility in global capital markets, along with low interest rates, the core banking profitability is falling dramatically. An additional impact related to the health emergency is the increased credit risk of corporate and retail clients of banking entities (ie, associated with forthcoming insolvency proceedings). Hence, banking entities are called to distinguish between these temporary situations (ie, management or reclassification) and other longer lasting impacts (ie, loan loss provisions) in order to continue financing the real economy.

However, the COVID-19 outbreak has also led to an acceleration of the digital transformation of the banking sector (ie, through partnerships and collaborations within the fintech industry), promoting the offering of an excellent customer experience.

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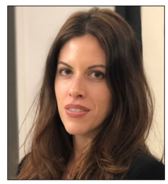

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CASES & LACAMBRA

# BENIN

## Law and Practice

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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Benin Banking System

Benin is a member of the West African Monetary Union (WAMU), the West African Economic and Monetary Union (WAEMU) and the Organization for the Harmonization of African Business Law (OHADA). The country has a banking system that includes:

- a National Agency of the Central Bank of West African States (BCEAO);
- a National Credit Council;
- banks,
- financial institutions; and
- a Professional Association of Banks and Financial Institutions (APBEF).

### Institutional Framework

At the international level, two institutions are responsible for regulating the bank's activities and operations. These are the Bank for International Settlements (BIS) and the Basel Committee (Basel I, II, III).

At the regional and national level, the Benin banking system is under the authority of the following community and national bodies:

- the Conference of Heads of State of the Union which defines the strategic orientations of the Union's institutions;
- the Council of Ministers of the West African Economic and Monetary Union which sets the legal and regulatory framework applicable to credit activity. It is currently chaired by the Minister of Economy and Finance of Benin;
- the Central Bank of West African States (BCEAO), the issuing institute common to the eight countries Member of the West African Monetary Union (WAMU) in charge of centralising the Union's foreign exchange reserves, managing the monetary policy of the Member of the Union, keeping the accounts of the Treasuries of the countries of the Union, and defining the banking law applicable to banks and financial institutions;
- the WAMU Banking Commission, a body responsible of banks and financial institutions control;
- the Personal Data Protection Authority (APDP); and
- the Court for the Repression of Economic Offences and Terrorism in the Republic of Benin (CRIET).

The Banking Commission has power over:

- licensing and withdrawal of licences of credit institutions (banks);
- supervision;
- administrative measures and disciplinary sanctions against the institutions subject to its jurisdiction or the managers responsible; and
- the appointment of provisional administrators or liquidators.

### Regulatory Framework

The operation of banks is governed by the following basic texts:

- WAMU and WAEMU treaties and the statutes of BCEAO;
- OHADA's uniform acts;
- the framework law on banking regulation internalised by Law No 2012-24 of 24 July 2012 on banking regulation in the Republic of Benin which determines the legal framework for the licensing, management and control of banks;
- the WAMU Uniform AML/CFT Law internalised by Law No 2018-17 of 25 July 2018 on the fight against money laundering and terrorist financing in the Republic of Benin;
- decisions of the WAEMU Council of Ministers and BCEAO instructions to banks and financial institutions;
- the convention governing the WAMU banking commission, which establishes the main regulator of banks in the Union;
- prudential regulations resulting from the recommendations of the Basel II and III Committees, in particular Decision No 013-24-06 CM UMOA relating to the prudential framework applicable to credit institutions;
- the classification agreement mechanism; and
- Law No 2017-20 relating to the digital code in the Republic of Benin.

These laws and regulations ensure the solvency and liquidity of banks, the protection of depositors and the security of the banking system as a whole.

# 2. Authorisation

## 2.1 Licences and Application Process

### Type of Licences and Statutory Procedures

In Benin, as in other WAMU member countries, no one may carry out a banking activity, claim the status of bank, banker or financial institution of a banking nature, nor create the appearance of such status without having been previously licensed and registered on the list of banks or on the list of financial institutions of a banking nature.

In order to promote financial integration within the West African Monetary Union (WAMU), the WAMU Council of Ministers instituted in 1998 the single licence for banks and financial institutions. This licence allows the bank to operate not only in the country where it was been obtained, but also in other countries of the Union (without applying for a new licence) after the formalities provided for by Community legislation to open branches have been completed.

Banks are constituted in the form of Joint Stock Company (*Société Anonyme*) with fixed capital having their registered office in Benin or other country member of WAMU; or by special authorisation of the Minister in charge of Finance given after approval of the Banking Commission, in the form of co-operative or mutual companies with variable capital. They may not take the form of a sole proprietorship and must have their registered office in the territory of one of the Member States of WAMU.

### Conditions and Procedures for Obtaining Licences

To obtain their licence (*agrément bancaire*), the company must be incorporated and the capital paid up to a certain level before sending an application for approval to the Minister of the Economy and Finance.

Requests for approval addressed to the Minister of Economy and Finance are filed with the Central Bank, which examines them. The Central Bank verifies whether the legal entities applying for authorisation meet the conditions and obligations provided for in Articles 25, 26, 29, 34 and 36 of the Banking Law in force. It also ensures that the legal form of the firm is appropriate for the activity of a bank or a financial institution of a banking nature.

In particular, the Central Bank shall examine the programme of activities, the technical and financial means that it plans to implement, as well as its plan for the development of the network of branches, agencies or counters, on a national and community scale. It also assesses the applicant company's ability to achieve its development objectives, under conditions compatible with the proper functioning of the banking system and sufficient protection of customers. The Central Bank obtains all information on the quality of the persons having ensured the capital contribution and, where appropriate, on that of their guarantors, as well as on the good repute and the experience of persons called upon to direct, administer or manage the bank and its agencies. In the course of this assessment, observations may be made to the promoters.

After examination of the file, the approval is pronounced by Order of the Minister of Economy and Finance, after approval by the Banking Commission of WAMU and the company is registered on the list of Banks or Financial Institutions of banking nature. These lists are drawn up, updated and published in the Official Gazette of Benin by the Banking Commission which assigns a registration number to each bank or financial institution of a banking nature.

Bank licence may be limited to the exercise of certain operations defined by the corporate purpose of the applicant.

Furthermore, the licence is deemed to have been refused if it is not pronounced within six months from the receipt of the application by the Central Bank, unless otherwise notified to the applicant.

### Other Conditions for Authorisation

The establishment of a bank or a duly authorised financial institution in a WAMU Member State other than Benin may be done under the legal status that the requesting bank or financial institution deems appropriate (branch, agency or subsidiary), subject to compliance with the legislation of the host country.

To carry out its activities under the single licence, any bank or financial institution shall submit to the competent authorities, in support of a declaration of intent, a technical file presenting in particular the financial aspects and the business plan of the new establishment. The declaration of intent and the establishment file are filed with BCEAO National Agency. The file is examined by the General Secretariat of the Banking Commission. The decision to set up a new structure within the framework of the single licence is taken by the Chairman of the Banking Commission, after consultation with the Minister in charge of Finance of the State where the requesting institution is duly approved in the Union (location of the head office) and that of the State of the new establishment.

The authorisation or refusal to set up is notified within a maximum period of three months from the date of receipt of the complete file.

### Activities and Services Covered, and Restrictions on the Activities of Licensed Banks

In accordance with the Banking Law, the receipt of funds from the public, credit operations, as well as the provision of customer services and the management of means of payment constitute banking operations. Banks are also involved in asset and magnetic card management activities and investment services.

Commercial, industrial, agricultural or service activities are prohibited to banks, unless they are necessary or incidental to the exercise of their banking activity or the collection of their debts.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

### Requirements Governing Change in Control

Regulators attach crucial importance to the ownership of banks and financial institutions. This is why any transaction having a significant impact on the shareholder structure must be carried out in accordance with the principles laid down in banking law. First of all, it should be recalled that during the licensing process, the Central Bank obtains all information on the quality of the persons who have provided the capital and, where applicable, on the quality of their guarantors.

Then, the authorisation of the Minister of Economy and Finance is also required for:

- the modification of the legal form, name or business name of the bank;
- the transfer of the registered office abroad;
- the merger by absorption or creation of a new company, or scission;
- early dissolution;
- the sale of more than 20% of the assets of the establishment corresponding to its operations in the country of establishment;
- the appointment of a management company;
- the cessation of all activities; and
- any acquisition or transfer of shareholding which would have the effect of increasing the shareholding of the same person, directly or through an intermediary, or of the same group of persons acting in concert, first beyond the blocking minority, then beyond the majority of voting rights in the credit institution, or to lower this shareholding below these thresholds — the blocking minority is defined as the number of votes that may prevent an amendment to the articles of association of the bank.

The application for prior authorisation, which is processed as for approval, is sent to the Minister of Finance and filed with the BCEAO National Agency. This authorisation is given after the Banking Commission has given its assent. However, the opening, closure, transformation, transfer, assignment or management of branches or agencies of credit institutions are simply subject to notification to the Minister of Finance and the Central Bank.

### The Nature of the Regulatory Filings and Related Obligations

As banks are incorporated as Joint Stock Companies (*Sociétés Anonymes*), they are also governed by the OHADA Uniform Act relating to Commercial Companies and Economic Interest Groups. With regard to change of control, OHADA law lays down the general principle of the free transferability of shares.

Notwithstanding this principle of free transferability set out in Article 764 of this Uniform Act, the bank statutes may stipulate certain limitations on the transfer of shares. Indeed, the articles may provide that the transfer of shares to a third party outside the company, either free of charge or for consideration, shall be subject to the approval of the board of directors or the ordinary general meeting of shareholders.

Apart from the provisions of OHADA law, the bank or financial institution of a banking nature must comply with BCEAO Instruction No 19-12-2011 establishing the list of documents and information constituting the prior authorisation file for the modification of the capital structure of the shareholders of credit institutions.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Relevant Statutory and Regulatory Requirements

In accordance with Circulars No 01-02-03-04-052017/CB/C relating to the governance of credit institutions and financial companies in WAMU, each bank must put in place a governance system in accordance with sound practices and adapted to its size, structure, the nature and complexity of its activities as well as its risk profile and, where applicable, that of the group to which it belongs.

A systemically important regional or national banking institution should have a governance framework appropriate to its size and to the consequences of its possible failure on the stability of the WAMU financial system or the country in which it is located.

In particular, the governance framework must:

- take into account the security of information systems, the coverage of all risks incurred by the institution and possible conflicts of interest;
- define the roles and obligations of stakeholders;
- meet the needs of the institution as a whole and of each of its organisational and operational units;
- incorporate mechanisms to maintain and/or restore its operations in the event of discontinuity; and
- reflect, over time, the changes resulting from the characteristics of the institution and its external environment.

### Control System

In accordance with Circular No 03-2017/CB/C relating to the internal control of credit institutions and financial companies in WAMU, the internal control system must include the interdependent components that are the control environment; risk assessment; control activities; information and communication; monitoring of control activities and correction of internal control deficiencies.

For the proper functioning of the control system, three levels of control are set up: permanent control, compliance and risk control and external auditors' control (statutory auditor, banking commission).

In this process, the main players in the bank have responsibilities.

#### *The decision-making body*

The decision-making body must oversee:

- the establishment and proper functioning of the internal control system in its design, implementation and steering phases;
- approve the organisational structure and ensure that the executive body monitors the effectiveness of the internal control system;
- ensure that the internal audit function has the appropriate means to carry out its tasks independently;
- review, at least once a year, the effectiveness of the internal control system, based in part on the information provided by the internal audit function, the statutory auditors and the Banking Commission; and
- commission, at least every five years, an external quality assurance review of the internal audit function.

#### *The executive body*

The executive body should develop appropriate internal control policies and procedures and monitor the adequacy and effectiveness of the internal control system; clearly define and maintain the structures, reporting lines, authorities and responsibilities for achieving the internal control objectives; and inform the internal audit function in a timely manner of all new developments, initiatives, projects, products and operational changes and related risks; ensure that appropriate measures are taken within the set deadlines to implement all corrective actions arising from the recommendations of internal audit, the statutory auditors or the Banking Commission; promote the independence of the internal audit function and provide it with the resources necessary to carry out its missions; report regularly to the legislative body on the effectiveness of the internal control system.

#### *The internal audit function*

The internal audit function is responsible for providing the governance bodies with reasonable assurance as to the quality and effectiveness of the internal control system, governance, risk management and compliance risk management systems in order to facilitate their control of the bank's activities and the risks incurred. It also makes proposals to the said bodies to enhance the effectiveness of these systems and mechanisms.

#### *Accountability rules*

Banks must communicate to the Central Bank and the Commission.

Banking, their annual accounts. These accounts must be certified regularly and truthfully by one or more auditors chosen from the list of auditors approved by the Court of Appeal or any other authorised body acting in its stead. The choice of the Statutory Auditor is subject to the approval of the Banking Commission.

### Voluntary Codes and Industry Initiatives

Depending on the size, number of employees, geographical location and activities, good practices in the organisation of services within the bank are based on three elements:

- a clear organisational chart;
- an efficient information system; and
- an appropriate accounting system.

There are also the internal regulations which define the modalities of organisation and functioning of the bank's organs; the code of ethics and deontology and the compliance charter which sets out the bank's Compliance Policy, defines the scope of action as well as the mission and general principles of organisation of the Compliance entity.

At industry level, the collective agreement applicable to banks and financial institutions in the Republic of Benin set some rules applicable to bank actors in particular to bank employees.

## 4.2 Registration and Oversight of Senior Management

### Directors' or Senior Managers' Designation

Any director, officer or manager of a bank or of one of its branches must be a Beninese national or that of a WAMU Member State, unless he enjoys, by virtue of an establishment agreement, an assimilation to Beninese nationals.

The Minister of Economy and Finance may grant, upon the approval of the Banking Commission, individual exemptions. They must not have been convicted of forgery or use of forged public documents, forgery or use of forged private, commercial or banking documents, theft, fraud or offences punishable by the penalties for fraud, breach of trust, bankruptcy or a ban on the practice of banking.

Credit institutions must:

- deposit the complete updated list of their directors and officers with the registrar in charge of the keeping of the trade and personal property credit register; and
- communicate, at the beginning of each semester, to the Banking Commission and the National Agency of BCEAO, the above-mentioned list, accompanied by the deposit receipt issued by the registrar in charge of the keeping of the trade and personal property credit register.

In the event that a director or executive ceases their activities before the end of the term, the credit institution must communicate the precise reasons to the Banking Commission and the National Agency of the BCEAO without delay.

#### Restrictions

The direct or indirect granting of credit to persons involved in the management, administration, control or operation of banks is limited to a percentage of their effective equity capital as determined by the Central Bank. The same limitation applies to credits granted to private companies in which the above-mentioned persons exercise management, administration or management functions, or hold more than a quarter of the capital.

In addition, any loan or guarantee granted by a bank to its managers, its main shareholders or partners or to private companies in which these persons exercise management, administrative or management functions or hold more than a quarter of the share capital must be unanimously approved by the members of the Board of Directors and be mentioned in the auditor's annual report.

However, individual and temporary derogations may be granted by the Minister of Economy and Finance, after obtaining the approval of the Banking Commission.

### 4.3 Remuneration Requirements

Under equal conditions of work, professional qualification and performance, the conventional wage is equal for all workers regardless of their origin, age, sex and status. Workers are paid according to classification, based on coefficients.

These coefficients are expressed in points. The value of the point is set by a joint committee of representatives of the employers who are members of the Professional Association of Banks and Financial Institutions (APBEF-BENIN) and the representatives of the employees' unions who are signatories to this agreement.

The collective agreement also provides for the payment of seniority bonuses, housing bonuses, cashier's bonuses (especially for cashiers) and diploma bonuses.

In addition, each employer has the option, depending on its financial possibilities, to pay an additional bonus of up to half a month or more of gross pay in December of the year in question.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

Article 11 of Law No 2018-17 of 25 July 2018 relating to the fight against money laundering and terrorist financing mentions that banks must defined a compliance policy and drawn up a compliance charter validated by the board of directors. This charter available for all staff, indicates the role of each person in the bank in managing compliance risks in accordance with the recommendations of WAMU/WAEMU, the FATF and GIABA (The Intergovernmental Action Group against Money Laundering in West Africa).

#### KYC Principles

Banks have duty of vigilance in their business relations, customer operations, in order to avoid financial crime risks. To this end, the compliance function should ensure the implementation of the risk-based approach recommended by the FATF to ensure that the bank operations abide with KYC and CDD principles especially the correct identification of the customer through:

- their identity document and their domicile or registered office;
- their registration number in the trade register if it is a company; and
- using siron software to determine the level of risk associated with each transaction.

For example, the detection of persons under international sanctions on the OFAC, USA, EU, etc, lists or prohibition of transactions to countries under embargo, identification of politically or financially exposed persons. The sanction screening software guarantees compliance with national and international sanctions and embargoes. The compliance function reviews high-risk files or clients and seeks the validation of the senior management to reject them.

In fact, the bank should not enter into commercial relations with persons, companies on blacklists, nor does it authorise transactions in their name or to their benefit. These prevention measure contribute to avoid or mitigate the risks of ALM and CTF.

**Control, Monitoring and Reporting of Suspicions**
To check and detect money laundering (placement, layering, integration), report is sent to the National Financial Information Processing Unit (CENTIF) on all transactions cash transaction of an amount equal or superior to CFA15 million. To this end, client must justify the origin or destination of the funds.

In a similar way, to facilitate the detection of unlawful transactions, compliance is required to keep recording on clients, conserve documents and send them at the request of legal authorities such as court for the repression of economic offenses and terrorism (CRIET).

Concerning the current operations or credit accounts monitoring, any suspicious or unusual transaction must be the communicated to the compliance function which is the interlocutor of the regulators. Then, Suspicious or unjustified transactions are delayed, suspended or blocked, and reported to CENTIF. This is the case, for example, for a transfer of funds involving explosives.

Furthermore, the "regulatory watch" section of the compliance function analyses and interprets news for example, when a client of the bank is involved in a financial scandal and it is necessary to block access to his account and retain the data to be transmitted to the national police, interpol or courts.

Finally, each transfer of funds is subject to a compliance check with regard to the originator, the beneficiary and the correspondent bank. IT teams help the bank to detect through software alerts, fraudulent transactions via internet banking and ensures that the institution's platform is not used as a relay for cybercrime activities.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

In order to ensure the protection of deposits of financial institutions, the WAMU Council of Ministers authorised BCEAO by Decision No CM/UMOA/017/09/2012, dated 28 September 2012 to create the WAMU Deposit Guarantee Fund (FGD-UMOA). Under the terms of BCEAO Decision No 088-03-2014, the mission of the fund is to ensure the guarantee of deposits of clients of Credit Institutions and Decentralized Financial Systems (SFD), approved in WAMU.

As such, it is notably responsible for:

- compensating depositors in case of unavailability of their assets, within the limit of a ceiling defined by the WAMU Council of Ministers;
- collecting subscriptions from members and mobilising all other resources necessary for the execution of its missions;
- managing the resources collected; and
- requesting reports from members.

Decision No 009 OF 30/06/2017/CM/UMOA fixed the contribution rates of members to the Deposit Guarantee Fund in the West African Monetary Union and the compensation ceilings for eligible deposit holders.

The statutes of the FGD-UMOA provides that deposits denominated in CFA francs and held by natural persons or legal entities, namely sight or time deposits; passbook and savings plan accounts; credit balance of current accounts or ordinary accounts; guarantee deposits when they become due; any other sum due to customers in respect of banking operations in progress on the day the accounts are closed, are guaranteed within the limit of the ceiling set by the Council of Ministers.

The annual contribution rate for WAMF-UMOA members is set at 0.06% of eligible deposits for banks. The compensation ceiling for holders of eligible deposits is CFA1.4 million per holder for all deposits held in the books of a bank.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

**The Scope of the Requirements**
In Beninese banking practice, respect for professional secrecy is provided for by the provisions of the Criminal Code, the Banking Act, the OHADA Uniform Act on General Commercial Law and the Convention establishing the Banking Commission.

Generally, all persons who, by state or by profession or by temporary or permanent functions, are custodians of secrets entrusted to them and who, except in the case where the law obliges or authorises them to act as whistle-blowers, have revealed such secrets, shall be punished.

Specifically, the Banking Law stipulates that persons involved in the direction, administration, management, control or operation of credit institutions are bound by professional secrecy. The same persons are prohibited from using confidential information of which they become aware in the course of their activity, to carry out transactions directly or indirectly on their own account or to pass on such information to other persons.

Furthermore, OHADA Law provides that the auditor and their staff are bound by professional secrecy with regard to facts, acts and information of which they may have become aware in the course of their work.

### Which Information is Caught?

Banks and financial institutions are obliged to maintain secrecy with regard to all facts which fall within the scope of banking activity and of which they have become aware in the course of the exercise of their profession. This concerns confidential information. It is thus forbidden for a banker to reveal to a third party the amount of an account balance or the amount of a credit granted to a client. Similarly, discounting operations for the provision of services the results of inspections and periodic controls carried out by the central bank are covered by banking secrecy.

### Main Exceptions Permitting Disclosure

Banking secrecy is not opposable to the BCEAO and the Banking Commission within the framework of the accomplishment of their missions. It is nevertheless useful to underline that the members of these institutions are also bound by professional secrecy.

Secrecy is also not opposable to the judicial authority acting within the framework of criminal proceedings, to the Tax Administration when it sends Third Party Holders Notices (*Avis à Tiers Détenteur*, or ATD) to banks. In Beninese practice, banks also receive requisitions from the Economic and Financial Brigade (BEF) and requests for information from CENTIF which they are obliged to respond to.

The statutory auditor (*Commissaires au Compte*) shall report, at the next general meeting, any irregularities and inaccuracies noted during the performance of their mission.

In addition, they shall disclose to the Public Prosecutor's Office any criminal acts of which they have become aware in the performance of their mission, without their liability being engaged by such disclosure.

### The Consequences of Breach

Breach of professional secrecy may result in two types of sanctions:

- a disciplinary sanction: dismissal for loss of confidence; or
- a penal sanction: the sanction provided for in the Beninese penal code is imprisonment from one month to six months and a fine from CFA100,000 to CFA500,000.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Adherence to Basel II and III Standards

After the banking crisis in WAMU in the 1980s to 1995 and the subprime crisis of 2007/2008, the regulatory environment for banks has evolved towards the efficient standards of banking supervision set by the Basel Committee. After adhering to the Basel, I standards, the monetary authorities reviewed and adapted the prudential framework that was in force to the new Basel II and III rules. The new rules came into force on 1 January 2018 in Benin and all WAMU member countries with transitional provisions up to 2022 previously but extended to 2023 due to COVID-19. The three pillars of Basel II and III are the minimum capital requirements, the principles of prudential supervision and the principles governing financial market discipline and transparency.

### Capital Requirements

To guarantee the financing capacity of banks and their solvency The Council of Ministers of the Union decided, in its ordinary session of 17 September 2007, to raise the minimum share capital applicable to banks of the West African Monetary Union (WAMU) to CFA10 billion.

The new prudential framework obliges banks to set aside sufficient capital to cover unexpected losses and remain solvent in the event of a crisis. The basic principle is that the amount of capital required depends on the risk associated with each bank's assets.

The regulatory capital requirements consist of:

- minimum capital requirements;
- the conservation buffer;
- the countercyclical buffer; and
- the systemic buffer.

It should be noted that, in accordance with the transitional provisions mentioned in Title X of the current prudential framework, the application of the regulatory thresholds will be phased in over several years to allow banks to adopt a gradual approach to absorb the new minimum capital requirements, incorporating the conservation buffer and leverage ratio. These transitional measures were extended to 2022 for the minimum capital and the maximum large exposures concentration ratio and 2027 for core and supplementary capital.

Due to the COVID-19 pandemic, the Council of Ministers of the European Union by decision dated 26 June 2020, published by BCEAO notice No 010-08-2020 of 10 August 2020 has extended by one year the timetable for the implementation of the transitional provisions of the prudential framework. Thus, the provisions planned for 2019 are maintained for 2020. The dates of entry into force of the requirements set for the following years, starting in 2020, are shifted by one year.

This measure of regulatory relaxation is part of the continued actions taken by the EU authorities to support economies in the face of the COVID-19 pandemic.

**Liquidity Requirements**
Financial institutions must hold sufficient liquid assets to cover net cash outflows over a period of 30 days in a crisis situation.

The institution must meet the requirements of both liquidity standards:

- the Short-Term Liquidity Ratio (RLCT); and
- the Structural Long-Term Liquidity Ratio (RLLT).

**Risk Control**
***Credit institutions***
This reform requires credit institutions to strengthen their governance, internal control and risk management. It should also reduce the asymmetry of information through transparency and financial communication, which require institutions to make information available to the public, in particular on compliance with capital requirements, risk management and governance arrangements. The new prudential framework should contribute to strengthening user confidence in the WAMU banking sector.

In accordance with Circular No 04-2017/cb/c on risk management in WAMU credit institutions and finance companies, each bank is required to have a risk management system adapted to its size, structure, the nature and complexity of its activities and its risk profile and, where appropriate, that of the group to which it belongs. The risk management system must be based on well-documented strategies, policies and procedures that make it possible to identify, measure, evaluate, monitor, report and control or mitigate all of the institution's significant risks.

Strategies, policies and procedures should be dynamic, reflecting changes in the institution's risk appetite, risk profile, market conditions and the macroeconomic environment.

***Banks***
The bank must ensure that strategies, policies and procedures are in place to provide an enterprise-wide view of its exposures to each type of risk, resulting in risk mapping and a comprehensive review at least once a year.

Banks are also required to set overall limits and operational limits at the level of the various entities in a consistent manner, in accordance with the institution's risk appetite, risk profile and capital base, and to set up an information system that provides capabilities for aggregating risk data and ensuring the timely transmission to the governing bodies of all relevant and useful information for their decision-making.

In addition to these standards, internal control standards must be rigorous, reporting to the governing body (at least once every six months) and reporting to the Banking Commission by sending an annual report on its overall risk management system by 30 April at the latest. This report, drawn up by the head of the risk management function, must be validated by the executive board.

In the context of the COVID-19 pandemic, the central bank has developed a support system for companies in difficulty by extending the due dates on their loans for a period of three months, renewable once, without interest charges, fees or late payment penalties. To this end, and to enable banks to continue financing savings, the prudential and accounting framework in force has been made more flexible and the BCEAO has authorised banks to classify their healthy loans that have been deferred due to the consequences of the health crisis in a specific account within the category of healthy loans, and not in the category of overdue loans.

From an accounting standpoint, these receivables will not, at reporting time, constitute a waiver of principal or interest and will not be subject to a discount or recognition as a loss. From a prudential point of view, these loans will benefit from the same weightings applicable to sound loans when calculating the capital requirements for credit risk.

In accordance with notice No 011-10-2020 of 14 October 2020 relating to the extension of the deferral period for the debts of credit institutions affected by the COVID-19 pandemic, these measures are valid until 31 December 2020.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

**Scope of Bank Resolution**
In accordance with the Annex to the convention governing the WAMU Banking Commission as amended by Decision No 010 of 29/09/2017/CM/UMOA and the statutes of the WAMU Deposit and Resolution Guarantee Fund, the resolution designates the set of rules governing arrangements for the prevention and management of banking crises. Systemically important banks in WAMU are subject to the resolution regime. A

resolution plan drawn up by the Resolution board sets out the measures that the latter is likely to take to deal with the failure of the bank concerned, on the basis of the information provided by the latter.

Under a resolution procedure, the Resolution Board is exempt from the requirement to obtain the authorisation or approval of any public authority necessary for the proposed transaction.

### Principal Means of Resolving a Failing Bank

#### *Preventive recovery plan*

Banks subject to the resolution regime must draw up their preventive recovery plans and have them validated by the Resolution Board.

#### *Conditions for entry into resolution and resolution measures*

At the request of the Supervisory Board, the Resolution Board may decide to dissolve any subject bank deemed to be unviable and with no prospect of a return to viability. The Resolution Board may take all measures necessary for the accomplishment of its mission, in particular:

- require any reporting institution, its managers, corporate officers, statutory auditors or employees to provide all information necessary for the implementation of the resolution procedure;
- appointing a special director responsible for implementing the resolution measures and executing the decisions of the Resolution Authority; any stipulation providing, within the framework of the contractual relations of the institution, that this appointment is considered as an event of default is deemed to be unwritten;
- remove or replace any manager whose responsibility for the situation of the institution is established;
- to decide on the automatic transfer of all or part of one or more branches of activity of the establishment;
- to decide on the use of an intermediary institution charged with receiving, on a provisional basis, all or part of the assets, rights and obligations of the institution in resolution, with a view to a transfer under the conditions laid down by the Banking Commission;
- to transfer to an intermediary institution or any other structure, the shares or corporate units issued by the institution;
- involve the Deposit Guarantee and Resolution Fund, in accordance with the provisions in force;
- impose a reduction in capital, the cancellation of equity securities or liabilities or the conversion of liabilities;
- require the institution to issue new shares or corporate units or other equity instruments, including preference shares and conditional convertible securities;
- impose, notwithstanding any provision or stipulation to the contrary, a temporary ban on the payment of all or part of the debts arising prior to the date of entry into the resolution;
- limit or temporarily prohibit the exercise of certain transactions by the institution;
- limit or prohibit the distribution of dividends to shareholders or remuneration of shares to members of the institution;
- decide on the termination of agreements involving financial obligations for the institution or the offsetting of debts and claims relating to such agreements; and
- suspend the exercise of the right to invoke the forfeiture of the term as well as the rights of termination and set-off, provided for in bullet point 13 above, of all or part of a contract concluded with the institution.

The Chairman of the Banking Commission shall inform the Minister of the Economy and Finance of the implementation of the termination measures.

The contradictory procedure may be conducted, as a regularisation, when the said measures are lifted, revised or confirmed.

#### *Recapitalisation*

The banking law in force in Benin provides that the Chairman of the Banking Commission may, if necessary, invite the shareholders, associates or members of the bank in difficulty to assist in its recovery. This could lead to recapitalisation.

He may also invite all members of the Professional Association of Banks and Financial Institutions to examine the conditions under which they could help the bank to recover.

#### *Putting the bank under provisional administration*

When the management of the bank jeopardises, the funds received on deposit or renders the Central Bank's claims non-liquid, the Banking Commission may decide to place the bank under provisional administration. It shall notify its decision to the Minister of Economy and Finance who shall appoint a provisional administrator to whom it shall confer the necessary powers for the direction, administration or management of the institution concerned.

The provisional administrator shall be appointed, within a maximum period of seven calendar days from the date of receipt by the Minister in charge of Finance of the said decision, from a list drawn up for this purpose by the Banking Commission. The appointment decision shall set the conditions of remuneration of the provisional administrator. The extension of the provisional administrator's term of office and the lifting of the provisional administration shall be pronounced by the Minister of Finance, in the same way.

The provisional administrator appointed to a credit institution, instead of its registered office, shall organise the provisional administration of branches established in other WAMU Member countries and which have benefited from the approval of the said institution. The provisional administrator appointed to a credit institution, instead of its head office, shall co-ordinate the provisional administration of branches established in other WAMU Member States and which have benefited from the authorisation of the said institution. They may be appointed, in the same manner, by the Minister in charge of Finance, a secondary provisional administrator for subsidiaries established on the territory of other WAMU Member States.

The provisional administrator must submit to the Banking Commission and the Central Bank, at least once every three months, a report on the operations they have accomplished as well as on the evolution of the financial situation of the credit institution. They must, in addition, submit to the Banking Commission and the Central Bank, during a period not exceeding one year from the date of his appointment, a report specifying the nature, origin and extent of the difficulties of the credit institution as well as the measures likely to ensure its recovery or, failing this, to establish the cessation of payments. The provisional administrator must complete his mission within the time limit set, in accordance with the terms of reference of his appointment.

***Merger with another bank***

An example of this in Benin is the merger of BIBE and BAIC.

***Interventions of the Deposit Guarantee and Resolution Fund***

The Deposit Guarantee and Resolution Fund intervenes at the request of the Resolution Board to finance resolution actions.

The Fund of Guarantee of Deposits and Resolution can only be called upon once all private financing solutions have been exhausted.

***Indemnification of creditors***

When the resolution procedure results in the liquidation of the bank, the Resolution board may decide to grant compensation to creditors, when the latter do not receive, as a minimum, what they would have received if the bank had been liquidated according to the liquidation procedure in force.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

**Determining the Regulatory Framework for Financial Inclusion**

The banking environment will be impacted by the implementation of the regional financial inclusion strategy with the development of mobile banking, the overall objective of which is to ensure, within five years (starting in 2018), the access and use of a diversified range of adapted and affordable financial products and services to 75% of the adult population of the WAEMU.

*Contributed by: Hélène Paty Kounake, **DHP Avocats***

**DHP Avocats** is a law firm founded in Benin by Hélène Paty Kounake, attorney at law and compliance officer. The team is composed of attorneys at law, fellow attorneys and partners, with a compliance and financial specialist, Gail Gibson CFP (RSA). The firm is active in regulatory, compliance, risk consulting and legal due diligence. The firm's practice covers banking, corporate finance, public finance and taxation. The firm assists clients in identifying and complying with the laws and regulations of Benin, WAMU/WAEMU and OHADA applicable to their activities and investments.

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# CYPRUS


## Law and Practice

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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

The main legislation governing the banking sector in Cyprus is the Business of Credit Institutions Law of 1997, Law No 66(I)/1997 (as amended) (the Banking Law). The Banking Law deals with the licensing, ownership and membership of banks as well as the winding up of banks, among other matters.

A number of directives have been issued by the Central Bank of Cyprus (the CBC) pursuant to the provisions of the Banking Law, including the Assessment of the Fitness of the Members of the Management Body and Key Function Holders of Authorised Credit Institutions Directive of 2020 (the Fitness Directive) and the Governance and Management Arrangements Directive of 2014 (the Governance Directive).

There are also various EU regulations relevant to the banking sector that have direct effect in Cyprus, including Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the CRR) and Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (Regulation 1024/2013).

The provision of payment services and electronic money services is regulated separately by the Law on the Provision and Use of Payment Services and Access to Payment Systems, Law No 31(I)/2018 (as amended) (the Payment Services Law) and the Law on Electronic Money, Law No 81(I)/2012 (as amended).

### Regulators

The regulators responsible for supervising banks in Cyprus are the European Central Bank (the ECB) and the CBC.

# 2. Authorisation

## 2.1 Licences and Application Process

### Requirement for a Licence

Subject to what is stated in the next paragraph, a bank must obtain a banking licence from the CBC before it commences its activities in Cyprus or its activities abroad from Cyprus.

A bank authorised and supervised by the competent authorities of another European Economic Area country (an EEA State) can carry out the activities listed in annex IV to the Banking Law in Cyprus (see below) without the need for a licence from the CBC, provided these activities are covered by its licence and that it complies with the relevant notification requirements to the CBC. Such a bank can operate in Cyprus through either the establishment of a branch or the provision of cross-border services.

### Activities and Services Covered

The activities and services covered by a banking licence include:

- taking deposits and other repayable funds;
- lending;
- financial leasing;
- payment services; and
- trading for own account or for customers in money market instruments, financial futures and options, among others.

The Banking Law prohibits banks from carrying out any commercial activity that is not one of the activities set out in annex IV to the Banking Law, unless the activity constitutes an ancillary services undertaking (as defined in article 4(1)(18) of the CRR).

### Conditions for Authorisation

A banking licence is only granted to a legal person established in Cyprus under the Companies Law, Cap. 113 (as amended) (the Companies Law) or to a credit institution established and authorised in a country other than an EEA State (a third country) under corresponding legislation of that country in order to operate in Cyprus through a branch.

The conditions for granting a banking licence include the following:

- the applicant must have separate own funds and an initial capital of at least EUR5 million, comprised of one or more of the items referred to in article 26(1)(a)-(e) of the CRR. The CBC can approve a smaller initial capital in certain cases;
- at least two persons must effectively direct the activities of the applicant;
- the members of the management body must be of good repute, have adequate knowledge, qualifications and experience, and meet the requirements specified in the Fitness Directive;
- the total composition of the management body must reflect a sufficiently wide range of expertise; and
- the applicant must inform the CBC of the identity of its shareholders or members, direct or indirect, that have qualifying holdings (as defined in the CRR) and of the amounts of those holdings or, if there are no qualifying holdings, of the 20 largest shareholders or members. The CBC refuses to grant the licence if it is not satisfied as to the suitability of the members or shareholders.

### Procedure for Applying for Authorisation

*Application form*

The application for a banking licence must be made in writing by or on behalf of the applicant to the CBC. No application fee is payable.

The application form must be accompanied by the following, among others:

- questionnaires set out in the policy statement on the licensing of banks in the Republic of Cyprus issued by the CBC. The questionnaires can be found on the CBC's website at https://www.centralbank.cy/en//licensing-supervision/banks/licensing-of-banks;
- memorandum and articles of association or any other incorporation document or a document determining the establishment of a legal person; and
- a business plan that describes the types of activities envisaged and the organisational structure of the applicant.

The CBC can require further information and/or documents.

*Timeline*

The CBC rejects the application if the applicant does not comply with the conditions for authorisation under national law. If the applicant complies with such conditions, the CBC must propose granting the authorisation but the ultimate decision is made by the ECB (Regulation 1024/2013).

If the CBC rejects the application, it must notify the applicant of its decision and the reasons for it within six months of receiving the application or, where the application is incomplete, within six months of receiving all the information required for the decision. Any decision by the CBC must be issued within 12 months of receiving the application.

If the CBC recommends the ECB grant the authorisation, the draft decision of the CBC is deemed to be adopted unless the ECB objects within a maximum period of ten working days, extendable once for the same period in duly justified cases. The ECB can object to the draft decision only where the conditions for authorisation set out in relevant EU law are not met. The ECB must state the reasons for the rejection in writing.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

### Requirements for Acquiring or Increasing Control over a Bank

*Qualifying holding*

Under the Banking Law, anyone who individually or in concert with others decides either to acquire, directly or indirectly, a qualifying holding in a bank established in Cyprus or to increase, directly or indirectly, such a qualifying holding, as a result of which the proportion of the voting rights or of the capital held by such person would reach or exceed 20%, 30% or 50% or so that the bank would become its subsidiary, must give prior written notice to the CBC setting out the size of the intended holding and other information required under the Banking Law. "Qualifying holding" is defined in the CRR as a direct or indirect holding in an undertaking which represents 10% 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.

*Assessment criteria*

From the date it acknowledges receipt of the notification and all documents required to be attached to the notification, the CBC has a maximum of 60 working days to assess the suitability of the prospective acquirer and the financial soundness of the proposed acquisition. The criteria which the CBC takes into account in making such assessment include, inter alia:

- the reputation of the proposed acquirer;
- the reputation, knowledge, competencies and experience (as defined in the Fitness Directive) of any member of the management body and of any senior manager who will direct the business of the bank as a result of the proposed acquisition;
- the financial soundness of the proposed acquirer; and
- whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being committed or attempted or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.

### Other Reporting Requirements

The Banking Law requires banks incorporated in Cyprus to inform the CBC upon becoming aware of any acquisitions of qualifying holdings in their capital that increase the thresholds referred to above.

In addition, under the Transparency Requirements (Securities Admitted to Trading on a Regulated Market) Law of 2007, Law No 190(I)/2007 (as amended), a person who acquires shares in a bank admitted to trading on a regulated market that carry the right to vote must, within the required time period, notify the bank and the Cyprus Securities and Exchange Commission (CySec) of the percentage of his voting rights if such percentage reaches or exceeds, as a result of the acquisition, 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75% of the total voting rights of the bank. The bank must notify the CySec and the Cyprus Stock Exchange (in its capacity as the national Mechanism for the Central Storage of Regulated Information) and publish the information on its website.

The Business of Insurance and Reinsurance and Other Related Matters Law of 2016, Law No 38(I)/2016 (as amended) imposes additional reporting requirements if the bank concerned holds shares in an insurance undertaking.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Law and Regulation

The main sources of a bank's corporate governance requirements are as follows:

- the Banking Law and directives issued by the CBC under the Banking Law (including the Governance Directive);
- the Companies Law, which deals with the formation and management of companies in Cyprus, among other matters; and
- common law (developed by case law). For example, the directors of a bank established in Cyprus are subject to a number of common law duties that apply generally to companies incorporated in Cyprus.

In addition, the articles of association of a bank incorporated in Cyprus regulate (subject to the provisions of the Companies Law) matters such as shareholders' and directors' meetings, the powers of the directors and transfers of shares.

The Banking Law requires that each bank has robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, and effective processes to identify, manage, monitor and report the risks to which it is or may be exposed, as well as adequate internal control mechanisms, including sound administration and accounting procedures and remuneration policies and practices that are consistent with and promote sound and effective risk management.

Such arrangements, processes and mechanisms must be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the bank's business model and activities.

### Management Body

The Governance Directive requires that, inter alia:

- the size and composition of the management body must take into account the size and complexity of the bank and the nature and scope of its activities, ensuring that:
  - (a) there are at least seven and not more than 13 members;
  - (b) at least 50% of the members of the management body (rounded down) plus one member are independent;
  - (c) there are at least two executive members, representing not more than 25% of the members of the management body (rounded down), one of whom must be the chief executive officer;
  - (d) the management body (i) is sufficiently diverse in age, gender and educational and professional background to reflect an adequately broad range of experience and facilitate a variety of independent opinions and critical challenge, and (ii) possesses adequate collective knowledge, skills and experience to be able to understand the bank's activities, including the main risks; and
- the management body must have committees of the appropriate size, composition, structure and responsibilities for the effective discharge of the management body's roles and responsibilities.

### Senior Management

Senior managers must be sufficient in number and have the necessary know-how to manage the bank's operations.

## 4.2 Registration and Oversight of Senior Management

### Assessment Procedure and Criteria

The procedure and criteria that banks should take into account in assessing the fitness of candidates for the management body and key function holders are set out in the Fitness Directive.

The Fitness Directive requires that the assessment of the fitness of members of the management body and key function holders is carried out before their appointment.

In particular, a bank must assess whether the candidate:

- has a good reputation;
- has sufficient knowledge, skill and experience to perform his duties;
- can act with honesty, integrity and independence so as to effectively assess and question the decisions of key function holders and to supervise and monitor the taking of decisions by senior managers; and
- can dedicate enough time to the performance of his duties and whether the limitations on the number of positions that

can be held by such person on other boards are complied with.

The bank must provide the CBC with the results of the assessment and, where the bank is a significant supervised entity, the CBC provides the results to the ECB. The relevant candidate is only appointed with the consent of the CBC or, in the case of significant supervised entities, the consent of the ECB.

### Roles of Management Body and Senior Management

#### *Management body*

According to the Governance Directive, the management body has the primary responsibility for internal governance. It must define, supervise and be accountable for the implementation of governance arrangements that ensure effective and prudent management of the bank, including the segregation of duties and the prevention of conflicts of interest. Such arrangements must comply with the following principles:

- the management body has the overall responsibility of the bank and approves and oversees the implementation of its strategic objectives, risk strategy and internal governance;
- the management body ensures the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards; and
- the management body oversees the process of disclosure and communications, and is responsible for supervising senior management.

Among other things, banks are also required to:

- have appropriate evaluation procedures for the performance of the management body as a whole, each committee and each individual member of the management body, which must be carried out at least annually;
- carry out through external consultants a review and evaluation of the composition, efficiency and effectiveness of the management body and its committees, at least every three years; and
- have appropriate policies and procedures for selecting, developing and, where necessary, replacing the chief executive officer or other senior managers, and have appropriate succession plans in place, having due regard to the importance and critical nature of their duties.

The management body of a bank is responsible for supervising senior management. It must establish appropriate policies, practices and procedures to ensure that senior management carries out its duties and responsibilities in accordance with the relevant provisions of the Governance Directive.

#### *Senior management*

The chief executive and other senior managers are responsible for directing and overseeing the effective management of the bank within the authority delegated to them by the management body, and in compliance with the applicable laws and regulations.

Senior management is responsible for the following, among other matters:

- managing and overseeing the day-to-day operations of the bank;
- providing the management body with recommendations on business objectives, strategies, business plans and major policies that govern the operation of the management body, for its review and approval; and
- providing the management body with comprehensive, relevant and up-to-date information that will enable it to review business objectives, business strategy and policies, and to hold senior management accountable for its performance.

## 4.3 Remuneration Requirements

The Governance Directive requires that every bank has remuneration policies and practices (including in respect of the salaries and discretionary pension benefits of, among others, senior managers, staff engaged in internal controls and risk takers) that are consistent with, and promote, sound and effective risk management.

The rules on remuneration policies include the following:

- taking into account the national criteria on wage setting, the remuneration policy must distinguish between (i) basic fixed remuneration, which should reflect relevant professional experience and management responsibility as set out in an employee's job description, and (ii) variable remuneration, which should reflect a sustainable and risk-adjusted performance as well as performance in excess of that required to fulfil the employee's job description;
- the total variable remuneration must not limit the ability of the bank to strengthen its capital base;
- banks must set appropriate ratios between the fixed and variable components of the total remuneration, applying the principles set out in the Governance Directive;
- at least 50% of variable remuneration should be equity, equity-linked or equivalent instruments or, where possible, other instruments set out in the Governance Directive; and
- payments relating to the early termination of a contract should reflect performance achieved over time and should not reward failure or misconduct.

A breach of the provisions of the Governance Directive may lead to the imposition by the CBC of administrative sanctions and measures. It is also a criminal offence punishable with a fine and/or imprisonment.

# 5. AML/KYC

## 5.1 AML and CTF Requirements

### Legislation

The main piece of legislation dealing with the prevention of money laundering and terrorist financing is the Law on the Prevention and Suppression of the Legalisation of Proceeds from Illegal Activities, Law No 188(I)/2007 (as amended) (the AML Law). As the supervisory authority for banks under the AML Law, the CBC has issued the directive on the prevention of money laundering and terrorist financing (the AML Directive).

### Procedures to Prevent Money Laundering and Terrorist Financing

Article 58 of the AML Law requires banks (among other persons) to implement adequate and appropriate policies, controls and procedures, proportionate to their nature and size, in order to mitigate and manage effectively the risks related to money laundering and terrorist financing, in connection with the following:

- client identification and due diligence;
- record keeping in relation to clients' identity and their transactions;
- internal reporting to the compliance officer (a senior staff member appointed by the bank to whom any information or other matter which proves or creates suspicion that a client is engaged in money laundering or terrorist financing activities should be reported) and reporting to the Unit for Combating Money Laundering;
- internal control, assessment and management of risk in order to prevent money laundering and terrorist financing;
- the thorough investigation of every transaction which, because of its nature, is considered particularly susceptible to be connected with offences related to money laundering or terrorist financing, especially complicated or unusually large transactions and all unusual transactions that are executed without an obvious financial or legitimate purpose;
- briefing and regular training of staff;
- risk management practices;
- compliance management; and
- recruitment and assessment of employees' integrity.

The AML Law requires banks to appoint a member of the management body to be responsible for the implementation of the provisions of the AML Law, any directives issued under the AML Law and any relevant acts of the European Union. The AML Law also requires the establishment, in certain cases, of an independent internal audit function, which will be responsible for verifying that the bank has established the policies, controls and procedures required under the AML Law.

### Supervisory Authority

As the supervisory authority for banks under the AML Law, the CBC evaluates and supervises the implementation by banks of the provisions of the AML Law and directives issued by the CBC under the AML Law. If a bank fails to comply with the provisions of the AML Law, the provisions of any directive issued by the CBC under the AML Law or the provisions of Regulation (EU) 2015/847 of the European Parliament and of the Council of 20 May 2015 on information accompanying transfers of funds and repealing Regulation (EC) No 1781/2006, the CBC may take any or all of the measures set out in the AML Law, which include the following:

- requiring the bank to take such measures within such time period as the CBC shall specify to remedy the situation;
- imposing administrative fines; and
- amending, suspending or cancelling the bank's licence.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

### Deposit Guarantee and Resolution of Credit and Other Institutions Scheme

The Deposit Guarantee and Resolution of Credit and other Institutions Scheme (DGS) was established and has been operating in Cyprus since 2000. The relevant legal framework consists of the Guarantee of Deposits and Resolution of Credit and other Institutions Law of 2016, Law No 5(I)/2016 (as amended) and regulations issued under it. The DGS constitutes a separate legal public entity and consists of the Deposits Guarantee Fund and the resolution of credit and other institutions fund (the Resolution Fund).

A management committee (the Committee) has been established to serve the purposes of and manage the Deposits Guarantee Fund and the Resolution Fund. The Committee consists of five members. The chairman is the governor of the CBC and the remaining four members are staff from the Ministry of Finance and the CBC (appointed by a decision of the governor of the CBC for a term of five years, which may be extended for a maximum period of three months).

The purposes of the DGS are to compensate the depositors of banks that pay contributions to the Deposits Guarantee Fund if a bank becomes unable to repay its deposits, and to fund the implementation of resolution measures.

**Covered Deposits**

All deposits (other than deposits excluded by the Deposit Guarantee and Resolution of Credit and Other Institutions Scheme Regulations of 2016 (as amended) – the Deposit Guarantee Regulations), in euro or other currency, held in banks and branches of a bank that operate abroad but pay a contribution to the Deposits Guarantee Fund (including accrued interest until the maturity date of the deposit or the date the deposit became unavailable, whichever occurred first) are eligible for compensation from the DGS.

The following categories of deposits are excluded by the Deposit Guarantee Regulations from the payment of any compensation from the DGS:

- deposits made by other banks on their own behalf and for their own account;
- own funds as defined in article 4(1)(118) of the CRR;
- deposits arising out of transactions in connection with which there has been a criminal conviction for money laundering in accordance with the provisions of the AML Law;
- deposits by financial institutions as defined in article 4(1)(26) of the CRR;
- deposits by investment firms;
- deposits the holder of which has never been identified when they have become unavailable;
- deposits by insurance and reinsurance undertakings;
- deposits by collective investment undertakings;
- deposits by pension and retirement funds, subject to certain exceptions;
- deposits by public authorities with an annual budget exceeding EUR500,000; and
- debt securities issued by a bank and liabilities arising out of own acceptances and promissory notes.

**Amount of Compensation**

Subject to what is stated below, the maximum amount of compensation for each depositor per bank is EUR100,000. This limit applies to the aggregate deposits held with a particular bank.

Deposits resulting from real estate transactions relating to private residential properties and deposits that serve social purposes are covered up to EUR300,000, in addition to the amount of EUR100,000 referred to above, for a maximum period of 12 months from the date on which the amount was credited or the date on which it can be legally transferred to the beneficiary, whichever is earlier.

When calculating the amount of compensation payable to a depositor, the deposits are set-off with all kinds of counterclaims the bank has against the depositor, provided and to the extent that these have become due before or on the date on which the deposits became unavailable, and provided further that such set-off is permitted in accordance with the statutory and contractual provisions that govern the contract between the bank and the depositor.

**Funding of the DGS**

Membership in the DGS is obligatory for all banks licensed in Cyprus, including branches of Cypriot banks that operate in other Member States.

The DGS is primarily funded from contributions from its members. Every bank that receives a licence in Cyprus must pay an initial contribution to the Deposit Guarantee Fund (currently amounting to EUR50,000) and then an annual contribution (calculated based on the covered deposits and the risk profile of each member).

In cases where the available financial means of the DGS are insufficient to repay depositors when deposits become unavailable, the members are also required to pay extraordinary contributions not exceeding 0.5% of their covered deposits per calendar year. Higher contributions may be required in exceptional circumstances.

The DGS is also allowed to obtain financing from loans or other means of support from third parties, and from the liquidation of assets or investments.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

**Statutory Duty of Confidence**

Under the Banking Law, members of the management body, chief executives, managers, officers, employees and agents of a bank – as well as persons who have access to the records of a bank by any means – are prohibited from providing, communicating, revealing or using for their own benefit any information whatsoever regarding the account of any particular customer of the bank, either during their employment or professional relationship with the bank or after its termination.

The Banking Law contains an extensive list of exceptions to the above prohibition, including the following:

- if the customer or his authorised representative gives their written consent for this purpose;

- if the customer has been declared bankrupt or, in the case of a company, is being wound up;
- if civil proceedings have been instituted between the bank and the customer or his guarantor in relation to the customer's account;
- if the information is provided to the police under the provisions of any law or to a public officer who is duly authorised under the relevant law to receive that information or to a court during the prosecution or the trial of a criminal offence under the relevant law;
- if the information is provided pursuant to the provisions of the AML Law;
- if the information is provided to the Cyprus tax department for purposes of compliance with the provisions of multilateral or intergovernmental agreements or with provisions of any law; or
- if the provision of the information is necessary for reasons of public interest or for the protection of the interests of the bank.

A breach of the relevant provisions of the Banking Law may lead to the imposition of administrative sanctions and measures by the CBC. It is also a criminal offence punishable with a fine and/or imprisonment.

### Contractual and Other Duties of Confidence

It is an implied term of the contract between a banker and his customer that the bank will not divulge to third persons either the state of the customer's account, or any of his transactions with the bank, or any information relating to the customer acquired through the keeping of his account. There are four exceptions to this duty:

- where disclosure is under compulsion by law;
- where there is a duty to the public to disclose;
- where the interests of the bank require disclosure; and
- where the disclosure is made by the express or implied consent of the customer.

The duty of confidence arises once the relationship of banker and customer is established. It does not cease when the customer closes his account, nor presumably after the customer's death.

Breach of the duty of confidence gives rise to a claim for damages.

Banks also have a common law equitable duty of confidence.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Implementation of Basel III

The Basel III standards developed by the Basel Committee on Banking Supervision have been implemented by the CRR (which is directly applicable in Cyprus) and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), which has been implemented in Cyprus by statute.

### Risk Management

*Rules*

The Banking Law requires that each bank has effective processes to identify, manage, monitor and report the risks to which it is or may be exposed and adequate internal control mechanisms, including sound administration and accounting procedures and remuneration policies and practices, that are consistent with and promote sound and effective risk management.

Banks incorporated in Cyprus are also required to have sound, effective and comprehensive strategies and processes to assess and maintain on a continuous basis the amounts, composition and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or may be exposed.

The Governance Directive sets out the following risk management rules for banks, among others:

- the risk management framework of a bank must extend to all its business activities, support functions and control units, and must recognise fully the economic substance of its risk exposures and encompass all relevant risks. The risk framework must also ensure that all material risks are identified and managed, including credit and counterparty risk, residual risk, concentration risk, liquidity risk and market risk;
- banks must ensure that appropriate, adequate and effective policies, systems, processes and procedures are in place for:
  - (a) identifying all relevant risks, existing and emerging, at the transaction and portfolio levels, on a continuous basis;
  - (b) assessing these risks and measuring the bank's exposures to them, at the transaction and portfolio levels, on an individual and a consolidated basis by recognising interactions between these risks, in an accurate and timely manner; and
  - (c) monitoring the risk exposures and determining the corresponding capital needs on an ongoing basis;

- assessment of risks must not solely or mechanically rely on external assessments such as external credit ratings or purchased risk models, but banks should strive to develop internal assessment capacity proportionate to the size, nature and scale of their activities. Purchased risk models should be validated and adjusted to the bank's individual circumstances to ensure accurate and comprehensive cover and analysis of its risk profile and risk capacity; and
- regular and transparent reporting mechanisms should be established so that the management body and all relevant functions are provided with up-to-date, accurate, concise, understandable and meaningful reports and can share relevant information on the identification, measurement or assessment and monitoring of risks.

#### *Risk committee and risk management function*

Banks are required to establish a risk committee and a risk management function. The duties of the risk committee include:

- advising the management body on the bank's overall current and future risk appetite and strategy;
- assisting the management body in overseeing the effective implementation of the risk strategy by senior management;
- assessing and monitoring the independence, adequacy and effectiveness of the risk management and information security functions; and
- advising the management body on the adequacy and effectiveness of the risk management framework.

The risk management function must be independent of the business and support units it monitors and controls, and must have the right to report its findings and assessments directly to the management body and the relevant committees, independent from senior management through clear reporting lines. It must:

- ensure that all material risks are identified, measured and properly reported;
- be actively involved in elaborating the bank's risk strategy; and
- have knowledge of the entire range of risks of the bank.

### Capital Requirements

The capital adequacy framework for banks in Cyprus consists of the CRR and the CRD IV (as implemented in Cyprus) which, among others, require banks to satisfy the following own funds requirements at all times:

- a Common Equity Tier 1 (as defined in the CRR) capital ratio of 4.5%;
- a Tier 1 (as defined in the CRR) capital ratio of 6%; and
- a total capital ratio of 8%.

In addition to the common equity tier 1 capital maintained to meet the own funds requirements imposed by the CRR, banks incorporated in Cyprus are required to keep a capital conservation buffer of Common Equity Tier 1 (as defined in the CRR) equal to 2.5% of their total risk exposure calculated in accordance with article 92(3) of the CRR, on an individual and consolidated basis.

Systemically important banks are required to maintain an additional capital buffer.

### Liquidity Requirements

In addition to meeting the general liquidity coverage requirement imposed under article 412(1) of the CRR, banks must ensure that long-term obligations are adequately met with a diversity of stable funding instruments under both normal and stressed conditions.

The Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (Regulation 2015/61) sets out rules specifying in detail the liquidity coverage requirement provided for in article 412(1) of the CRR. Regulation 2015/61 has been directly applicable in Cyprus since 1 October 2015, with the following transitional provisions:

- 60% of the liquidity coverage requirement from 1 October 2015;
- 70% from 1 January 2016;
- 80% from 1 January 2017; and
- 100% from 1 January 2018.

The CBC has issued a directive to banks on the computation of prudential liquidity in all currencies, which sets out the principles that banks should implement for the management of liquidity risk.

### Leverage Ratio

The CRR requires banks to calculate their leverage ratio and report it to the CBC, but it does not impose any particular leverage ratio requirement.

The CRR has been amended by Regulation (EU) 2019/876, which has introduced a leverage ratio requirement of 3%. The relevant amendment will apply from 28 June 2021.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

**Legal Framework**

The relevant provisions relating to the winding-up of banks incorporated in Cyprus are set out in part XIII of the Banking Law and part V of the Companies Law, and in winding-up rules issued under the Companies Law.

The recovery and resolution regime for banks is based on:

- Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (the Resolution Regulation); and
- the Resolution of Credit Institutions and Investment Firms Law of 2016, Law No 22(I)/2016 (the Resolution Law), which implements the provisions of 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.

**Resolution Regime**

***Resolution authority***

The Resolution Regulation establishes the Single Resolution Board, which is responsible for drawing up the resolution plans and adopting all decisions relating to resolution for, among others, the entities referred to in article 2 of the Resolution Regulation (including banks established in Cyprus) that are not part of a group, and groups considered "significant" under article 6(4) of Regulation (EU) 1024/2013.

In relation to other entities and groups (ie, those not listed in article 7(2) of the Resolution Regulation), the CBC in its capacity as the Resolution Authority is responsible for, among others, adopting resolution decisions and applying resolution tools in accordance with the provisions of the Resolution Law (unless the Resolution Board decides, under the Resolution Regulation, to exercise the relevant powers in relation to any such entity or group). The Resolution Law applies to banks established in Cyprus and, subject to the conditions set out in the Resolution Law, to branches of banks of third countries established in Cyprus.

The Resolution Authority must obtain the approval of the Minister of Finance before it implements decisions that have a direct financial impact or systemic consequences.

***Resolution action***

The Resolution Authority takes action for the resolution of a bank only if it considers that the following conditions are met:

- the CBC considers, after consultation with the Resolution Authority, that the bank is insolvent or is likely to become insolvent;
- there is no reasonable prospect that any alternative private sector measures or supervisory action taken in respect of the bank would prevent the bank's insolvency within a reasonable timeframe; and
- a resolution action is necessary for the public interest.

**Resolution Tools**

The resolution tools under the Resolution Law are as follows:

- sale of business tool;
- bridge institution tool;
- asset separation tool; and
- bail-in tool.

The Resolution Authority can apply the resolution tools individually or in any combination, except that the asset separation tool can only be applied together with another resolution tool.

***Sale of business tool***

The Resolution Authority has the power to demand the transfer of the following to a purchaser that is not a bridge institution:

- shares or other instruments of ownership issued by a bank under resolution; and
- all or any assets, rights or liabilities of a bank under resolution.

A transfer made under this tool is made on commercial terms and is considered to be valid without obtaining the consent of shareholders of the bank under resolution or any third person other than the purchaser, and irrespective of any restriction imposed by law, contract or otherwise.

***Bridge institution tool***

The Resolution Authority can transfer the following to a bridge institution:

- shares or other instruments of ownership issued by one or more institutions under resolution; and
- all or any assets, rights or liabilities of one or more institutions under resolution.

A transfer made under this tool (as well as the asset separation tool) is made without obtaining the consent of the shareholders of the bank under resolution or any third person and without complying with any procedural requirements under company or securities law. The bridge institution is a legal person wholly or partly owned by the Resolution Fund and is controlled by the Resolution Authority.

***Asset separation tool***
The Resolution Authority has the power to transfer assets, rights or liabilities of a bank under resolution or a bridge institution to one or more asset management companies. An asset management company is a company wholly or partly owned by the Resolution Fund and is controlled by the Resolution Authority and manages the assets transferred to it with a view to maximising their value through eventual sale or orderly wind-down.

***Bail-in tool***
The Resolution Authority has the power to demand the application of the bail-in tool for any of the following purposes:

- to recapitalise a bank to the extent sufficient to:
  - (a) restore its ability to comply with the conditions of its licence;
  - (b) continue to carry out the activities for which it is authorised; and
  - (c) sustain sufficient market confidence in the institution; or
- to convert to equity or reduce the principal amount of claims or debt instruments that are transferred:
  - (a) to a bridge institution with a view to providing capital for that bridge institution; or
  - (b) under the sale of business tool or the asset separation tool.

The Resolution Law gives the Resolution Authority all the powers necessary to apply the resolution tools to banks, including the power to take control of a bank under resolution and exercise all the rights and powers conferred on the shareholders, other owners and the management body of the relevant bank.

The Resolution Regulation contains the same resolution tools as the Resolution Law, and the powers of the Resolution Board under the Resolution Regulation are similar to the powers of the Resolution Authority.

**Deposits**
All deposits that are eligible for the payment of compensation from the DGS are fully protected up to the maximum amount set out in the Deposit Guarantee Regulations in the event resolution measures are taken in relation to a bank. All other deposits rank pari passu in a bank's resolution.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

There are no upcoming regulatory developments.

**Georgiades & Pelides LLC** is a leading Cypriot law firm with a broad corporate, banking, commercial and litigation practice and a distinct international focus. The firm was formed in 1998 by the merger of Georgiades & Georgiades with Nicos Pelides & Co, and offers a unique blend of dynamism and experience. It currently has 18 lawyers (including partners). Georgiades & Pelides LLC advises on all aspects of banking law, including secured commercial lending, project and corporate finance, the raising of loan finance, the enforcement and realisation of securities, leasing and hire purchase. It has advised many banks and financial institutions on transactions involving sovereign guarantees, derivatives, drafting of margin account trading documentation and multi-currency loan facility agreements, as well as syndicated project finance transactions. It also advises on the regulatory regime relating to banks in Cyprus, including the establishment and acquisition of banks and substantial stakes in such institutions.

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# EGYPT

## Law and Practice

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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

Law No 194 of 2020 Issuing the Central Bank and Banking Sector Law (the "New Banking Law") was introduced on 15 September 2020, and replaced the previous banking legislation, the Central Bank Law of 2003 (the "Old Banking Law"). Its main feature is its level of detail and its coverage of many subjects that were unaddressed in the Old Banking Law, and it expanded on and/or clarified some existing topics, such as the following:

- an expanded supervisory and regulatory role for the Central Bank of Egypt (CBE);
- data privacy and security;
- clarification and organisation of the process for taking collateral for foreign banks;
- consolidation of the government's approach of generalising cashless payments (in tandem with Law 18 for 2019 regarding cashless payments);
- clear permissibility for repo transactions;
- capitalisation requirements; and
- the creation of a licensing regime for fintech and e-payments activities.

In addition to this new legislation, the CBE also routinely issues regulatory directions and circulars on a range of topics complementing the New Banking Law and providing guidance on the implementation of the law. The CBE is considered the bank of the government and can guarantee funds raised by different governmental entities. It also maintains reserves of foreign currencies and may provide bailouts to distressed banks subject to certain conditions.

# 2. Authorisation

## 2.1 Licences and Application Process

A licence for operating banking activities in Egypt must be given through a process detailed in the New Banking Law under supervision from the CBE. The CBE also oversees the licensing of foreign currency exchange firms, credit rating agencies and operators of payment systems.

Banking activities are defined in the New Banking Law as activities that include the acceptance of deposits, raising funds, and the investment of funds in debt and equity financing, in addition to any activities customarily considered as banking activities.

A banking licence can be given to a joint-stock company, a branch of a foreign bank, or a representative office. The board of the CBE can grant a preliminary approval for a banking licence to any joint-stock company or a branch of a foreign bank subject to certain conditions, as follows.

- The issued and paid-up capital must be at least EGP5 billion. This shall be USD150 million or its equivalent for branches of foreign banks.
- The ultimate beneficial owners can be clearly identified from the ownership structure and the legitimacy of the capital funds are established.
- The licensing must not contravene the general economic interests in Egypt.
- It must not jeopardise the competition and antitrust laws.
- The name of the bank must not be similar to any other bank operating in Egypt.
- The applicants must demonstrate a solid financial and economic feasibility study that includes the objectives and targeted operations, in addition to a market study on how to employ assets.
- The bank must have clear internal auditing and risk management systems and shall identify the governance and other strategic policies followed in its operations.
- Furthermore, the branch of a foreign bank or the applicants for a licence of joint-stock companies that have a parent financial institution must show that such foreign bank or parent institution is regulated under the framework of a regulator similar to the CBE. The consent of such regulator must be obtained, and the branch must further accept that it will exchange information and co-operate with the CBE in implementing its role.

Applicants for a banking licence must submit their request accompanied by all the mentioned documents and information. The fees for submitting an application for a preliminary approval of a banking licence is EGP1 million for a joint-stock company and USD50,000 for a branch. The board of the CBE must issue its decision within 90 days from completion of the submission.

If the application is approved, the applicants must finalise the establishment of a joint-stock company or a branch, as the case may be, within one year from the approval in relation to joint-stock companies and six months in relation to branches. Then the preliminary approval and all required documents will be submitted a second time for the final approval of the board of directors of the CBE.

The licensing for branches of a foreign bank has an additional step that requires foreign banks to guarantee all the deposits of the branch and the rights of its creditors. The registration of a new bank or a branch must then be annotated in the register of banks maintained by the CBE. The fees for this are EGP500,000 for the headquarters and EGP250,000 for any branch registered, or EGP150,000 for small branches or offices.

It is further allowed for foreign banks to establish a representative office in Egypt after obtaining a licence from the CBE. The activities of a representative office must always be limited to market studies and investment opportunities. These entities are not allowed to perform any commercial or banking activities.

The New Banking Law also includes several other provisions that provide for the licensing of foreign currency exchange firms, payment facilitators and payment aggregators. However, these provisions leave the details of the licensing processes to be decided by the board of directors of the CBE.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

The ownership of share capital in Egyptian banks is allowed equally for Egyptians and foreigners, whether individuals or companies, subject to several rules that relate to the percentage of ownership. Any ownership between 5 and 10% of the issued share capital or voting rights of a bank requires the owner to notify the CBE within 15 days from the date of acquiring ownership.

If an ownership of the bank-issued share capital or voting rights is anticipated to be more than 10%, then the prior approval of the CBE must be obtained. Any request to acquire more than 10% of a bank-issued share capital must be submitted at least 60 days prior to the date of acquisition. The applicant must demonstrate solid financial creditworthiness and its objectives from acquisition detailed by the strategies of participating in its management.

An applicant for a percentage of more than 10% of an issued share capital of a bank must also clarify its own capital and ownership structure (if a company) and identify all its related parties and ultimate beneficial owners. The CBE checks whether the applicant enjoys the financial capabilities and expertise to support the capital structure of the bank and implement its objectives without adversely affecting competition in the banking industry.

If the applicant is a foreign bank, the consent of the regulatory authority in its jurisdiction must be obtained to allow for the co-operation and sharing of information between the CBE and such authority. The CBE must reply to the applicant within 60 days, and if approval is given, the applicant must finalise the acquisition within six months from the approval date.

## 4. Supervision

### 4.1 Corporate Governance Requirements

The New Banking Law and the Governance Instructions issued by the CBE on 23 August 2011 (the "Governance Instructions") must be read together as a comprehensive guideline for governance rules in the banking sector. The CBE also issues regular circulars addressed to the senior management and boards of directors of banks to provide instructions in certain matters of corporate governance.

### 4.2 Registration and Oversight of Senior Management

The appointment of senior executives in banks must be approved by the Governor of the CBE in accordance with Article 120 of the New Banking Law. Senior executives are defined as chairpersons, board members and executive directors of the main and oversight activities as specified in detail by the board of the CBE. The approval of the Governor is necessary for vetting the technical competence and capabilities of the candidate prior to appointment.

The senior executives must observe the following principles in performing their roles.

- Complying with the laws and regulations, and having the due care required for their profession.
- Co-operating with the CBE and reporting any incidents of material breach.
- Supervising and ensuring that operations are efficient within their departments and delegating their powers to competent personnel. However, a senior executive will remain responsible for any matters delegated to others.
- Providing information to clients with transparency and avoiding any conflicts of interest.

The member of the board of directors of any bank must not be, at the same time, a member of a board of any other bank or credit agency. The member cannot participate in management or consultancy activities with other banks or credit agencies as well. Also, a bank may not extend lending or guarantee the facilities of its chairman, board members, auditors, or any of their spouses or second-degree relatives, including any companies in which these persons have a controlling stake.

### 4.3 Remuneration Requirements

The Governance Instructions provide that a committee of three non-executive board members must be established in each bank to set the rules and recommendations for the remuneration scheme of senior executives and board members. The financial remuneration includes matters such as salaries, allowances, in-kind benefits, share schemes and any other bonuses or financial benefits.

The committee has certain guidelines to follow, such as the following.

- The auditing roles in the bank must be given adequate remuneration without exposing their independence.
- A comparative study with other institutions must be conducted to attract talent and maintain it.
- A written policy must be in place and this policy has to be reviewed and updated regularly. The board of directors shall ratify the policy and disclose the aggregate amount of the 20 highest-paid individuals in the bank.
- A performance-based approach must be applied in deciding the level of financial remuneration, and, specifically, long-term assessment criteria must be adopted rather than relying on short-term goals.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

The Anti-Money Laundering Law No 80 of 2002 (the "AML Law") regulates the methods and obligations of different stakeholders to combat money laundering and the financing of terrorism. The AML Law imposes certain obligations on financial institutions to apply "know your customer" measures prior to establishing a relationship with clients or undertaking certain transactions.

Any bank must request documentation evidencing the ultimate beneficial ownership of any new corporate client. This must be supported by declarations and a list of shareholders or partners for each shareholder of the entity as established in each jurisdiction. This line of ownership must be traced by the bank up until the ultimate individuals vested with beneficial ownership to scrutinise any relationship with terrorist organisations or money laundering activities.

The bank must further request all other documents supporting the due incorporation and legitimate activities of the shareholders of the client, such as the articles and memorandum of association, the certificate of registration, and the lists of directors and shareholders. This information must be reviewed and updated regularly by the bank throughout the term of the relationship with its clients.

The obligations of banks under the AML Law extends also to monitoring the transactions processed within the bank and reporting any suspicious activities on accounts. This might require the bank to request from the client supporting documents for deposits, money transfers, or trade transactions to check that the funds are not passing through sanctioned countries or the hands of terrorists and sanctioned groups.

The CBE has created an anti-money laundering and terrorist combating unit in its structure to receive any suspicious reports from banks in this respect. Each branch of a bank must appoint an anti-money laundering officer who is responsible for processing any alarms raised by the operation staff and reporting incidents to the combating unit of the CBE.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

Chapter 14 of the New Banking Law provides that a fund, affiliated to the CBE, must be established for guaranteeing the deposits of a bank's clients. This fund, the Guarantee of Deposits Fund (GDF), has an independent legal personality and separate financial statements. The GDF must have articles of association that provides for many things, including:

- the mechanism of how the fund will achieve its goals and regulate its relationship with banks;
- the structure of its board of directors and work systems;
- the share of participation in its capital for each bank, and the annual fees of membership;
- the limits and amounts of deposits that can be guaranteed by the fund; and
- the sources for raising funds and investment opportunities.

The CBE has the power to impose penalties on banks if they breach any of the articles of the fund or the related implementing decisions. In reality, the articles of Chapter 14 of the New Banking Law have not been implemented and no GDF has been established to date.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

The New Banking Law considers that the information of banks' clients is confidential and cannot be disclosed. This includes information such as bank accounts, deposits, safe locks and any related transactions. The bank must not allow the disclosure of this information to any party unless with the prior written consent of the account holder or a proxy or delegate is obtained. This obligation of confidentiality is a continuing one and remains even after the relationship between the bank and the client ends.

Certain exceptions apply to the secrecy of account information, such as in cases of a court order or an arbitral award allowing the disclosure of information during a lawsuit or arbitral proceedings. Also, if the investigations of a felony or misdemeanour require the disclosure of account information, the public prosecutor or any of its delegated senior public lawyers may apply for the permission of the Cairo Court of Appeal to disclose this information.

Any person who receives account information during the course of their job must not disclose this information to any other person. This obligation remains even after the person leaves their job. The New Banking Law also provides that the confidentiality of account information does not apply in the following situations:

- for the performance of the roles and responsibilities of the auditors of a bank;
- when the bank is obliged to issue a reasoned rejection to the beneficiary of a returned cheque;
- when a bank is suing a counterparty in a legal dispute and the disclosure of certain client information is necessary for that purpose; and
- in the event of a necessary disclosure in accordance with the AML Law.

Any breach in the obligations of confidentiality and secrecy of clients' information under the New Banking Law is penalised by a period of imprisonment of not less than one year and/or a fine ranging between EGP200,000 and EGP500,000.

## 8. Prudential Regime

### 8.1 Capital, Liquidity and Related Risk Control Requirements

#### The CBE's Adoption of the Basel III Guidelines

The CBE adopts the guidelines of Basel III through its regulatory circulars and decisions addressed to the banks. There is a dedicated sector within the structural organisation of the CBE that is entrusted with several aspects of the adoption of Basel requirements. The Basel Sector of the CBE regularly follows up the latest updates in the Basel requirements and seeks methods to implement them in the banking sector. It further updates the guidelines in Egypt and conducts training for employees in co-ordination with foreign regulatory bodies and authorities.

All banks operating in Egypt are required to maintain a minimum capital ratio of at least 10% of their risk-weighted assets to mitigate any credit, market, or operational risks. This applies to the bank on a consolidated basis, including any group companies that operate banking activities or financial institutions (except for insurance companies) in which the bank or its related parties own more than 50%, or any other controlling percentage.

The capital basis, as defined by the CBE regulations, consists of two tiers. Tier 1 is the core capital (common equity) and additional capital (additional going concern). The core capital consists of ordinary shares representing the issued and paid-up capital, in addition to retained earnings and any reserves (for example, legal reserves and capital reserves).

This core capital excludes any treasury shares, intangible assets, receivables from securitisation transactions, deferred recoverable tax assets, and investments in insurance and financial companies subject to certain percentages. The core capital is also adjusted to exclude certain provisions made for non-performing loans, reserves of foreign currency discrepancies and cash-flow risks, among other things.

The additional capital consists of preferred shares, interim profits or losses, minority rights, and the discounted value of any shareholder loan calculated based on the interest rate of treasury bonds. The supplementary capital must comply with certain guidelines, such as that it has to be issued and paid-up capital, ranking behind depositors and creditors, unsecured, and unconditional or not recoverable by the right-holders unless with certain parameters.

#### The Identification of Systematically Important Local Banks in Egypt

In addition, the CBE has regularly followed the developments and updated rules issued by the Basel Committee on Banking Supervision, including an initiative to conduct a study in 2017 to specify the systematically important local banks in Egypt.

In order to identify the systematically important banks locally, the CBE assigns a relative weight for certain indications, including the aggregate exposure used in calculating the leverage, aggregate deposits, assets held with other local banks, liabilities due for other banks, volume of payments settled, assets held with offshore banks, and labilities due for offshore banks.

The CBE then assigns five categories of systematically important banks based on the mentioned criteria. These banks have more requirements on their additional capital to ensure a higher loss absorbency ability. The additional capital requirements for systematically important banks range between 1.25% for category 5 and 0.25% for category 1. These criteria for identifying the systematically important banks are revisited regularly by the CBE in case of any market developments within periods that do not exceed three years.

The CBE has also issued several circulars concerning the requirements of a minimum capital conservation buffer, and the maintenance of certain liquidity coverage ratios, in addition to other rules to mitigate concentration risks and interest rate risks related to trading books of banks. All banks in Egypt, except branches of foreign banks, are required to comply with the ratios specified by the CBE to manage their credit, market and operational risks.

# 9. Insolvency, Recovery and Resolution

## 9.1 Legal and Regulatory Framework

The financial distress of any Egyptian bank is regulated by Chapter 12 of the New Banking Law, which excludes banks from the purview of the Restructuring, Reconciliation, and Bankruptcy Law No 11 of 2018, which is the general legislation regulating the bankruptcy of companies in Egypt. The New Banking Law designates the CBE as the authority entrusted with regularising the status of banks in financial distress. For that objective, the CBE is given wide powers and tools to put into effect the provisions of the New Banking Law.

Chapter 12 of the New Banking Law aims to achieve general objectives such as maintaining the stability of the banking system, protecting the interests of depositors, mitigating losses for creditors, and avoiding the utilisation of public funds in any settlement process. The guiding principles include proportionality of the measures with the level of distress, absorbing any losses through equity rights as an initial resort, and giving all creditors of the same rank similar treatment.

The CBE may issue a decision that a bank is in financial distress in the following cases:

- the financial position is poor or the interests of depositors are subject to risk;
- the bank failed to meet its liabilities in respect of depositors or other creditors;
- the bank's liabilities exceeded the value of its assets;
- the value of the bank's shareholders' rights is decreased in comparison with the allocations that should be formed;
- if the bank fails to have access to funding resources or the financial markets;
- the bank failed to adhere to the limit of the capital adequacy ratio or the liquidity ratio, or any other applicable supervisory ratios decided by the CBE's board of directors;
- the value of the bank's assets or profits has decreased significantly in a way that threatens its ability to operate;
- the bank is relying on exceptional and onerous financial resources to conduct its normal course of business;
- the bank did not undertake the procedures related to the early intervention prescribed by the New Banking Law under Article 147; or
- the branch of a foreign bank failed to meet its liabilities as well as the bank's headquarters as per the unconditional security provided pursuant to Article 68 of the New Banking Law, and the competent authority did not issue a decision to settle the bank's status in the state of its headquarters within the period determined by the board of directors of the CBE.

In all cases, early intervention or any other procedures are not deemed as conditions precedent to initiate the settlement process for the distressed bank.

Notwithstanding the above, the CBE may issue a decision that a specific bank is in financial distress if any of the following cases, among others, that cancel the licence and registration of the bank by virtue of the board of directors of the CBE are realised:

- the commitment of a gross or continued violation by the bank according to the provisions of the New Banking Law or the issued decrees in this regard, provided that such violation has not been rectified within the period determined by the board of directors of the CBE;
- the bank has followed a policy that negatively affects the general economic interest, the monetary policy, the banking system, or the depositors' interests;
- the bank ceased to operate, or has presented a liquidation request by choice or a request to suspend its activities;
- the licence has been issued based on incorrect data that has been provided to the CBE;
- one of the licensing conditions is missing; or
- the data given in respect of the issuance of a licence has been materially changed.

The board of directors of the CBE may cancel the licence and registration of the bank subject to settlement in the following cases:

- the bank's status may not be reconciled or restructured; and
- the bank's assets or liabilities have been fully or partially transferred to another bank or to the interim bank.

The cancellation decision shall not be issued unless the relevant bank has been notified to present its defence arguments in writing within 15 days of the date of notice. The licence cancellation decision will be published in the Egyptian official gazette within ten days of its issuance date. It will also be published on both the CBE's and the relevant bank's websites for the entire period of liquidation.

The CBE is entitled to issue a reasonable decision that a bank is in financial distress and to initiate the settlement of its status. Such decision shall be valid for a period of one year as of the publication date or the date upon which the relevant party is notified of such decision (as the case may be). The board of directors of the CBE is entitled to cancel the decision issued in respect of the settlement of the distressed bank's status at any time if the reasons for the issuance of such decision no longer exist.

If the CBE has decided that a bank is in financial distress, the consequences will be as follows:

- all the competencies related to the general ordinary and extraordinary assemblies, the board of directors and the executive administration will be transferred to the CBE unless otherwise decided by the CBE;
- the distribution of any profits or any other form of capital distribution to the shareholders or others will be suspended;
- the disbursement of due payments to the main executives will be suspended, except those related to the business or services decided by the CBE; and
- any lawsuits filed by the creditors against the bank under settlement will be suspended, for a period of 90 days as of the date upon which the bank's financial distress was published.

The CBE may also reschedule all the dues owed by the bank for a period not exceeding 60 days, except the clients' deposits. The CBE may also suspend the application of early termination of financial contracts to which the bank under settlement is a party according to certain regulations.

The CBE will undertake to prepare a report including the inventory of the assets and liabilities of the bank under settlement.

The CBE may undertake any of the below procedures, upon publishing that a bank is in financial distress without obtaining the approval of the bank's shareholders, creditors or debtors.

- Dissolving the distressed bank's board of directors and appointing a delegate to carry out the management activities.
- Suspending fully or partially the bank's operations or certain activities.
- Reducing the nominal value of the bank's shares or reducing the issued shares.
- Recapitalising the bank by issuing new shares or any other tradable securities.
- Reducing the value of some of the bank's liabilities or transferring such liabilities to shares in its capital or in the interim bank.
- Terminating or amending any provisions of any contract or bond from debt securities to which the bank under settlement is a party.
- Assigning all or some of the rights, liabilities and assets owned by the distressed bank to another bank or the interim bank.
- Merging the distressed bank with another bank or transferring its title to shares.
- Filing civil lawsuits claiming compensation or in order to receive any monies. Such lawsuits will be filed against any of the shareholders or main executives or the employees responsible for such financial distress.

As per the New Banking Law, if the settlement process of a distressed bank requires the approval of the Financial Regulatory Authority or any other competent authority, such request shall be reviewed within three business days as of the application date.

Moreover, the CBE may prepare a plan to reschedule, reduce or recapitalise all or some of the liabilities of the bank under settlement to enhance its ability to successfully operate, noting that the below liabilities shall be excluded from such plan:

- the clients' deposits without the deposits of the related parties of the bank under settlement;
- the taxes, the social insurance and the CBE dues;
- the debts secured by a guarantee, or transferred or tangible assets; and
- the salaries of the bank's employees.

In the event of undertaking the settlement process, the CBE is obliged to consider the following:

- ranking the preference of the creditor as shown under Article 175 of the New Banking Law, without prejudice to the authority of the CBE to eliminate any obligations as shown under the second paragraph of Article 163 of the New Banking Law; and
- applying the principle of reciprocity for creditors with the same ranking, unless non-compliance is mandatory to maintain the stability of the banking system given the impact of the negative consequences that the distressed bank would have on the rest of the banks, or to increase the value of the bank subject to settlement in favour of the group of the creditors.

Furthermore, in the event that any of the creditors or shareholders have borne, as a result of the settlement of the distressed bank, losses more than the losses that would have been borne in the event of liquidating the bank pursuant to the provisions of the law regulating the restructuring, preventative reform and bankruptcy issued by virtue of Law No 11 of 2018 by ranking the preference of the creditors as mentioned in Article 175 of the New Banking Law, they will be compensated for such losses from the distressed bank's settlement fund. Such losses shall be evaluated by an independent expert appointed by the CBE, taking into account the exclusion of financial support provided by the government to the bank that is the subject of the settlement, and this is pursuant to the regulations and procedures specified by virtue of a decree issued by the board of directors of the CBE.

As per the New Banking Law, the ranking of debt payments to the creditors of the bank subject to liquidation in the event of insufficiency of its assets to cover its liabilities and after the settlement and payment of secured debts shall be as follows:

- the liquidator and delegate expenses;
- the deposits of clients, except the deposits of the related parties of the bank subject to liquidation;
- the salaries (within six months prior to the appointment of a liquidator) due to the employees of the bank subject to liquidation;
- the government dues that arose from the financing of settlement operations or the financing provided by the CBE on behalf of the government;
- the taxes, dues and insurances of the employees working prior to the appointment of the liquidator;
- the debts provided to the bank by the private sector after announcing the settlement of its status or the appointment of a liquidator; and
- the unsecured debt.

Creditors with the same ranking shall be treated equally. Creditors with a lower ranking shall not be entitled to claim their dues until the settlement of the indebtedness of the higher rank.

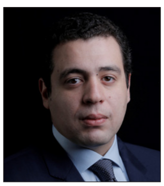
## 10. Horizon Scanning

### 10.1 Regulatory Developments

The New Banking Law was only recently issued, in 2020, and no executive regulation has been issued to date.

**Matouk Bassiouny & Hennawy** is a leading, full-service, MENA region law firm with offices in Egypt (Matouk Bassiouny & Hennawy), the United Arab Emirates (Matouk Bassiouny & Ibrahim), Sudan (Matouk Bassiouny in association with AIH Law Firm) and Algeria (Matouk Bassiouny in association with SH-Avocats), as well as a country desk covering its Libya practice. The firm's attorneys specialise in advising multinationals, corporations, financial institutions and governmental entities on all legal aspects of investing and doing business in the MENA region. The Finance & Projects group's primary goal is to provide its clients with legal advice on the banking and finance sector in Egypt, as well as the strengths and weaknesses of security available to lenders in the Egyptian market. Headed by Mahmoud Bassiouny, the group maintains close relationships with Egyptian financial institutions, which enable it to have first-hand knowledge of what constitutes commercially acceptable solutions for major institutions involved in large-scale deals.

## Authors



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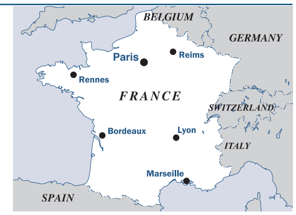
# FRANCE

## Law and Practice

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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

The legislation governing banking activities in France is designed to promote a flexible framework for lending and other banking activities while providing a high degree of legal certainty and a strong supervisory framework.

Over the past 20 years, French banking and finance legislation has evolved from a national set of rules to a modernised legal framework integrating EU initiatives and the development of global capital markets. More recently, the digital transformation of the banking and financial services has appeared to be an unavoidable structural shock which has brought its share of regulatory changes.

Three main layers of rules and regulations apply to banking activities:

### EU Law

Most of EU regulations is directly applicable in France. This includes principally:,

- the Single Supervisory Mechanism (SSM) and other rules regarding a harmonised European regulatory framework applying to banking institutions;
- the Single Resolution Mechanism (SRM);
- the CRD IV package, which transposes the global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework (including Directive 2013/36/EU on capital requirements (CRD IV) and Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms (CRR)); and
- other sectoral regulations such as Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (Securitisation Regulation).

### French Legislation

Most of this is codified into the Monetary and Financial Code (*Code Monétaire et Financier*) (M&FC) which has recently been amended, in particular in relation to:

- the separation of banking activities, which requires the separation of own-account trading activities from other activities and imposes bans on certain other activities;
- the resolution and recovery of credit institutions;
- certain services like e-banking, financial services, consumer credit services, payment services (which are no longer part of the French banking monopoly rules), electronic currencies and fintech; and
- certain products like derivative products, securitisation transactions or issuance of bonds.

### *Other French legislation*

- Directive 2014/65/EU on markets in financial instruments (MiFID II) has been implemented by an Ordinance of 23 June 2016 which entered into force on 3 January 2018, in respect of automated and algorithmic negotiation, inducements, distribution of financial instruments and investment advisory activities;
- money laundering rules have been reinforced by an Ordinance of 12 February 2020 implementing the Directive (EU) 2018/843 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (Fifth Anti-money Laundering Directive);
- anti-corruption legislation has been strengthened by the Law of 9 December 2016 (*Loi Sapin II*), principally by extending whistle-blowing in the financial sector to any non-complying behaviour, not only to market abuse, and requiring large French companies (with more than 500 employees and a turnover above EUR100 million) to implement compliance programmes for fighting corruption;
- Order No 2017-748 of 4 May 2017, which introduces under French law a new regime for security agents;
- Ordinance No 2017-970 of 10 May 2017, reforming the French bond issuance regime;
- Ordinance No 2017-1252 of 9 August 2017, which implements under French law the Directive (EU) 2015/2366 of 25 November 2015 on payment services in the internal market (PSD 2) (later ratified by Law No 2018-700 of 3 August 2018;
- Ordinance No 2017-1433 of 4 October 2017 on the dematerialisation of contractual relations in the financial sector: the purpose of this Ordinance is to regulate the new services provided by banking and financial institutions, such as "digital-safe" or "secure personal space";
- Law No 2019-486 of 22 May 2019 relating to the growth and the transformation of the companies (*Loi Pacte*), which amends banking and financial regulation, for example on banking intermediaries, regulated savings, the recognition of foreign payment systems and strengthening the control of foreign investment, the adoption of measures to mitigate the effect of a no-deal Brexit and restricting the scope of the banking monopoly, among others; and
- Ordinance No 2019-740 of July 17, 2019 relating to the civil sanctions applicable in the event of default or error of the effective rate (*taux effectif global* or TEG).

### Regulatory Authority Rregulations

Banking activities are also regulated by detailed regulations enacted by regulatory authorities such as the European Central Bank (ECB), the Prudential and Resolution Control Authority

(*Autorité de Contrôle Prudentiel et de Résolution*) (ACPR) or the Financial Markets Regulator (*Autorité des marchés financiers*) (AMF).

## 2. Authorisation

### 2.1 Licences and Application Process

#### Types of Licences for Which a Firm Can Apply

There are several types of banking and financial services licences, depending on the type of business being carried out by the relevant institution. The main licences are the credit institution licence, the investment services licence and payment service-provider licence.

The conduct of banking and financial activities in France is generally restricted to French and European licensed institutions. Credit institution licences have been granted, since 2014, by the ECB, while the provision of investment services requires a licence that is delivered by the ACPR. Portfolio management companies must be authorised by the AMF.

***Credit institution licence***

Under French law, only authorised credit institutions and financing companies are authorised to enter into credit transactions on a regular basis and only authorised credit institutions may receive funds from the public on a regular basis; these restrictions are generally referred to as the French banking monopoly.

Activities requiring a banking licence include the following banking transactions carried out on a regular basis:

- receipt of funds repayable from the public;
- credit transactions (including the purchase of non-matured receivables (*créances non-échues*));
- banking payment services.

Financial leases are considered to constitute credit transactions when the relevant lessee is granted an option to buy the leased asset.

***Exceptions to the banking monopoly***

There are various exceptions to the requirement to hold a banking licence in respect of certain types of transactions.

By way of example, with respect to the receipt of funds repayable from the public, a banking licence is not required for:

- funds received from a third party with instructions to allocate them to a specific operation and provided that the person receiving the funds does not have the right to use them on their own account;
- funds received by a company or partnership from its partners or shareholders;
- funds received by a company from another company within the same group under specified conditions;
- funds raised through the issuance of securities and negotiable debt securities.

As for credit transactions, no banking licence is required in the following situations:

- payment delays granted by a company to its customers;
- certain loans and advances granted by a company to its employees;
- loans granted by a company to another company within the same group where those companies are linked by capital ties, as a result of which one of them has control over the other;
- delivery of cash collateral in the context of a securities-lending operation;
- buying or selling securities, negotiable debt securities or government securities as part of a repurchase agreement.

Recent legislation created new exceptions to the requirement to hold a banking licence in respect of:

- crowdfunding companies operating in France;
- intercompany credits not exceeding two years granted to small- and medium-sized companies with which a business relationship is maintained by the lender;
- loans granted by certain French regulated funds.

***Investment services licence***

An investment service licence must be obtained by investment firms whose regular and main business includes the provision of investment services, certain credit institutions that have been specifically authorised to conduct investment services activities, and portfolio-management companies.

Investment service-providers are generally licensed by the ACPR, which, prior to issuing an investment services-provider licence, consults the AMF for approval. As an exception, portfolio-management companies are licensed by the AMF.

***Scope of investment services***

Investment services are defined by French law with reference to the MiFID, as amended by the MiFID II and Regulation (EU) 600/2014 on markets in financial instruments (MiFIR).

Under French law, investment services on financial instruments (financial securities and financial contracts) include the following services:

- receipt and transmission of orders for third parties;
- executing orders for third parties;
- trading on own account;
- portfolio management for third parties;
- underwriting financial instruments;
- placing of financial instruments without a firm commitment basis;
- providing investment advice;
- operating a multilateral trading facility.

***Exceptions to the investment service licence requirement***
The following French financial institutions are allowed to carry out all or some of the investment services without holding an investment service licence:

- public bodies such as the Treasury (*Trésor public*), the French Banque de France;
- insurance companies;
- Collective investment schemes (*Organismes de placement collectif en valeurs mobilières* - OPCVM) (Undertakings for the Collective Investment in Transferable Securities - UCITS);
- alternative investment funds (including closed-ended funds, professional funds, and real estate investment vehicles);
- providers of a limited number of services (commodity brokers) or of investment services as an ancillary activity;
- institutions for occupational retirement;
- financial investment advisers (*conseillers en investissements financiers*) which are governed by specific provisions.

Tied agents (*agents liés*) can also be appointed by an investment service-provider to receive and transmit orders, place financial instruments on a firm (or non-firm) commitment basis and provide investment advice, as long as the relevant investment service-provider is authorised to provide those services.

***Licensing for the conduct of payment services or issuance of electronic money***
Regulations applying to payment services and means of payment have been streamlined by the Directives on payment services in the internal market.

The provision of payment services and the issuance of electronic money are no longer exclusively covered by the monopoly of credit institutions, as specific categories of financial institutions regulated by the ACPR and benefiting from the European passport can also perform these activities (that is, payment institutions that perform payment services and electronic money institutions can issue electronic money). As an exception, credit institutions still have a monopoly in respect of the performance of banking payment services, but this essentially just consists of the issuance of cheque books.

An institution can apply to the ACPR for a simplified payment institution licence (*établissement de paiement simplifié*) if:

- it is expected that the payment volumes handled by the institution will not exceed a monthly average of EUR3 million; and
- the institution does not plan to provide a fund transmission service, a payment initiation service or account information services.

Similarly, if it is expected that the volume of electronic money in circulation will not exceed a monthly average of EUR5 million, it is possible for an institution to be licensed as an electronic money institution with a light regime. In both cases, the prudential requirements are adjusted, notably in terms of initial capital, capital requirements and internal control.

***Licensing for the conduct of digital asset services***
The French legislator has enacted a simple and attractive regime for Digital Assets Service Providers (DASPs).

DASPs can offer services related to tokens which are not considered as financial securities or currencies. The DASPS can benefit from this new French regime and apply for an optional licence delivered by the AMF.

The AMF is the unique point of contact for those applying for a licence or registration (registration is mandatory only for two categories of services). The process should take under six months when the application file is complete.

Digital asset services covered by the law are:

- storage of digital assets or private cryptographic keys on behalf of third parties;
- buying and selling of digital assets against legal currencies;
- exchange of digital assets against other digital assets;
- operating a trading platform for digital assets.

Other services include:

- reception and transmission of orders of digital assets on behalf of third parties;
- portfolio management of digital assets on behalf of third parties;
- advice to subscribers of digital assets;
- underwriting of digital assets;
- guaranteed investment of digital assets;
- non-guaranteed investment of digital assets.

Registration is mandatory only for the first two services. The AMF will publish a list of registered service-providers.

***Separation of banking activities***
French credit institutions, financial companies and mixed financial companies are prevented as a matter of principle from carrying out certain activities that are considered to be risky. They are, however, allowed to conduct these activities through a dedicated subsidiary where the relevant transactions exceed exposure thresholds defined by decree of the Minister of the Economy (7.5% of the size of the balance sheet on the entity concerned, based on the accounting value of the assets corresponding to the trading activities on financial instruments).

These activities include the trading on financial instruments for own account, with certain exceptions.

The dedicated subsidiary must be licensed as an investment firm or credit institution. It is prevented from carrying out high-frequency trading subject to tax under Article 235ter ZD of the General Tax Code and Transactions on financial instruments using, as underlying assets, an agricultural commodity.

While the separation of banking activities is inspired by the Liikanen Report, it diverges from the conclusion of that report in some key areas. For example, it excludes market-making activities, which is perceived as a key tool to facilitate access to liquidity.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

**Significant Shareholdings Reporting**
Credit institutions must report annually to the ACPR specific financial information relating to significant shareholders (holding 10% or more of a credit institution's voting rights).

**Threshold-Crossing Obligations**
Any modification of the shareholding structure of a credit institution must be notified to the ACPR.

Any transaction enabling a person acting alone or in concert with other persons to acquire, increase, reduce or cease to have, directly or indirectly, a participation in a bank must be authorised by the ACPR before it is carried out, when either (Order of 4 December 2017):

- the fraction of voting rights held by that person or persons exceeds or falls below one tenth, one fifth, one third or one half; or
- the credit institution becomes or ceases to be the subsidiary of that person or persons.

The ECB, on a proposal of the ACPR, will decide whether to oppose the contemplated change of shareholding structure (Article 4 and 15, Regulation No 1024/2013 of 15 October 2013).

**Acquisition of Shareholdings and of Control of Banks**
Both banking institutions and non-financial undertakings are allowed to take participations in or to control credit institutions. However, they must submit to the ACPR a request for prior authorisation for the acquisition of:

- effective control over the management of the institution;
- one third, one fifth or one tenth of the voting rights in the institution.

For other changes affecting the ownership of a credit institution, only a declaration to the ACPR is required.

The ACPR will assess the suitability of the proposed acquirer and the financial soundness of the proposed acquisition with the view to ensuring the sound and prudent management of the relevant credit institution, and having regard to the likely influence of the proposed acquirer. In doing so, it will take into consideration:

- the reputation of the proposed acquirer;
- the reputation, knowledge, 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, in particular in relation to the type of business pursued and envisaged in the credit institution in which the acquisition is proposed;
- whether the credit institution will be able to comply and continue to comply with the applicable prudential requirements, including whether the group of which it will become a part has a structure that makes it possible to:
  - (a) exercise effective supervision;
  - (b) exchange information effectively among the competent authorities; and
  - (c) determine the allocation of responsibilities among the competent authorities;
- whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.

In the case of a change in the ownership of a credit institution, the request for prior authorisation is processed by the ACPR and then sent to the ECB for a final decision under the Single Supervisory Mechanism.

Specific rules also apply to the acquisition by credit institutions of a business line (*branche d'activité*) of another credit institution.

The acquisition by banks of all or part of a significant business line of regulated entities must be authorised by the ACPR in accordance with Article L. 511-12-2 of the Monetary and Financial Code.

A "business line" is one of the following elements acquired directly or through the takeover by a special-purpose vehicle, of:

- a business (*fonds de commerce*) of a credit institution, financing company, investment firm, payment institution or electronic money institution;
- a set of balance sheet assets relating to:
  - (a) banking transactions, excluding transactions carried out by mortgage credit companies (*société de credit foncier*) and transactions carried out by housing finance companies (*société de financement de l'habitat*) or equivalent operations outside France;
  - (b) a portfolio of debt securities; or
  - (c) a portfolio of financial contracts.

**Foreign Shareholdings in Banks**

As a general rule, declaration obligations apply to foreign investments realised in France when the investment (i) results in the constitution of a subsidiary; and (ii) exceeds EUR15 million.

More importantly, the ACPR can require (subject to certain limited exceptions) foreign investors intending to control a credit institution to provide a sponsor, unless the investors are significant banking entities.

# 4. Supervision

## 4.1 Corporate Governance Requirements

**Legal Forms Generally Used to Operate as Banks**

French law requires credit institutions and financing companies to be legal entities without imposing a specified corporate form, as long as the corporate form chosen is appropriate with regard to the proposed activities. The most commonly used corporate form for credit institutions is a limited liability company (*société anonyme*) whose main decision-making body is the board of directors, which must comprise at least three members.

**Legislative and Non-legislative Corporate Governance Rules for Banks**

The main corporate governance rules applicable to credit institutions include:

- management by at least two senior managers;
- the separation of the functions of the chairperson and of the chief executive officer (CEO) and the availability of the bank's managers;
- permanent and periodic control functions;
- management of risks by a risk committee; and
- specific compensation rules.

The Monetary and Financial Code requires credit institutions and financing companies to be organised and operated in such a way that at least two senior managers have a comprehensive and detailed view of all its business activities (four-eyes rule).

Credit institutions and financing companies must generally have:

- robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility;
- effective processes to identify, manage, monitor and report the risks to which they are or might be exposed;
- adequate internal control mechanisms, including sound administration and accounting procedures; and
- remuneration policies and practices that are consistent with and promote sound and effective risk management and, as the case may be, a preventive recovery plan.

In addition, staff engaged in control functions must be independent from the business units they oversee. With respect to investment services-providers, the compliance function is entrusted with an Investment Services Compliance Officer (RCSI) who must have a professional licence granted by the AMF.

## 4.2 Registration and Oversight of Senior Management

The management of a credit institution's risks is entrusted to its (Order of November 2014):

- board of directors; and
- executive body with regard to the certain types of risks (for example, credit risk, market risk, global interest rate risk, intermediation risk, liquidity and settlement risk and operational risk, including internal and external fraud risk).

French law imposes specific requirements of availability, competency and integrity on the individuals who are effectively managing a credit institution. They must be fit and proper, in order to secure the sound and prudent management of the institution. Ordinance 2014-158 of 20 February 2014, which implements the CRD IV package, extends these requirements to all members of the board of directors or the supervisory board of the credit institution or the financing company. Further, Ordinance 2014-158 introduces a new requirement with respect to the management of credit institutions. It is now prohibited to combine the roles of chairman (of the board of directors or of the supervisory board) and chief executive, unless justified by the institution and authorised by the ACPR.

Certain governance requirements only apply to institutions deemed systemically important financial institutions (SIFIs), such as:

- limits on appointments to officer and director positions; and
- the requirement to set up a nomination committee, risk committee and compensation committee.

The European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) published joint guidelines on 26 September 2017 (in force on 30 June 2018) on assessing the suitability of members of the management bodies and key functions' holders. They published guidelines on internal governance on the same date. The ACPR has since declared its intention to comply with this second guideline and, subject to certain reservations, with the first guideline.

### 4.3 Remuneration Requirements

The Law of Banking and Financial Regulation of 22 October 2010, transposing the requirements of Directive 2010/76/EU on capital requirements for the trading book and for re-securitisations and the supervisory review of remuneration policies (CRD III), established remuneration criteria requiring certain credit institutions and financing companies to establish a remuneration committee and to structure remuneration packages according to certain standards.

The CRD IV package, which came into force on 1 January 2014, strengthens this framework and has been transposed into French law by the Banking Reform Law and Ordinance 2014-158 of 20 February 2014. This Ordinance:

- specified the criteria for the remuneration policy;
- expanded the area of intervention of remuneration committees;
- created an obligation to consult the shareholders of the company; and
- set rules for variable remuneration.

French regulations have specified the application of the proportionality principle by setting thresholds and exemptions of the application of remuneration provisions for several kinds of entities, including entities which belong to a banking group and have a total balance sheet of less than EUR10 billion and which do not pose a risk to the solvency and liquidity of the group.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

The French Anti-Money Laundering legislation (Articles L. 561-1 et seq of the M&FC), as amended by the Ordinance No 2020-115 of 12 February 2020, has implemented the fifth EU Directive regarding Money Laundering (Directive 2018/843/EU).

Credit institutions, investment services-providers, insurance companies, notaries, together with a host of other organisations and institutions are subject to KYC requirements and must identify the effective beneficiary of the business relationship, including where there is no suspicion of money laundering or financing of terrorism.

The French Anti-Money Laundering Regulation encompasses two main duties: (i) a "know your client" (KYC) duty which involves identification of the customer and of the beneficial owner and the knowledge of the business relationship; and (ii) a duty to report any suspicious transaction to TRACFIN (which is the organisation responsible at the French Treasury for monitoring the fight against money laundering and the fight against terrorism – LCB-FT).

In accordance with a proportionality principle, the intensity of due diligences can be alleviated in the case of a low risk and should be increased if the risk is higher. Due diligence must be recorded and kept by the relevant financial institution in order to be available to French authorities upon request.

Suspected transactions are to be reported to TRACFIN who may block the completion of such transactions and may also report the matter to the prosecutor for criminal prosecution.

The main new provisions brought by the Ordinance No 2020-115 of 12 February 2020 include:

- an extension of the list of persons subject to obligations relating to the fight against money laundering and the financing of terrorism in line with European requirements;
- adjusting customer due diligence obligations;
- adjusting the rules relating to the supervisory authorities for the LCB-FT;
- increasing the transparency requirements for information on beneficial owners; and
- extending measures to combat money laundering and terrorist financing to French overseas entities.

In addition, France law allows the French government to take economic sanctions and restrictive measures against foreign states or organisations.

French restrictive measures and sanctions can be taken as a result of:

- sanctions decided by the United Nations (UN);
- sanctions implemented at the European level (EU Rules);
- sanctions decided and implemented at the national level by French authorities.

Such restrictive measures and sanctions taken against a specified foreign state may:

- prohibit, or restrict, the trade of targeted goods, technologies and services; or
- freeze the assets of specified persons, organisations and entities; or
- freeze financial or commercial transactions (including loans or exports).

When taken against persons, organisations and entities, French restrictive measures and sanctions may freeze their assets, sums and economical resources, as well as their financial or commercial transactions.

French Restrictive measures and sanctions may be adopted by a decree of the French Government or by an order (*arrêté*) of the Minister of economy (alone or jointly with the Home Security Minister) pursuant to certain provisions of the M&FC (Article L. 151-2, L. 562-2 and L. 562-3 of the M&FC implemented pursuant to the provisions of Article L. 562-4 to L. 562-15 of the M&FC).

In order to implement Resolution 1373 (2001) at the national level, France adopted a law, dated 23 January 2006, which instituted a regime of freezing of assets of terrorists, as implemented under Article L. 562-1 of the M&FC. This regime is mainly applied to freeze the assets of persons who are present in France and who pose a terrorist threat.

It should be noted that the regime described above and pertaining to the French regime's restrictive measures and sanctions has been recently modified by Ordinance No 2020-1342 of 4 November 2020, strengthening the mechanism for freezing assets and prohibiting their provision.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

Depositor's protection in France is implemented through a device whereby licensed credit institutions must adhere to a deposit and resolution guarantee fund (*fonds de garantie des dépôts et de résolution*) established under the provisions of Article L. 312-4 of the Monetary and Financial Code. Its main purpose is:

- to manage and implement the arrangements for the guarantee of deposits (that is, to indemnify depositors in the case of unavailability of their deposits or of other refundable funds); and
- to finance the resolution arrangements for credit institutions.

The Resolution Guarantee Fund is established as a legal entity created under private law. It is managed by a management board operating under the supervision of a supervisory board. The Minister of Economy, the Governor of Banque de France, President of the ACPR or the President of the AMF may request to be heard by such bodies.

### Deposits Covered by the Deposit Guarantee Scheme

The deposit guarantee scheme is implemented upon the request of the ACPR as soon as it finds that a credit institution is no longer able to return, immediately or in the future, the funds protected by that scheme, ie, any deposit of up to EUR100,000 of any holder of the following accounts:

- current accounts;
- cash and term-deposit accounts;
- savings accounts;
- deposits made to the cash accounts of stock savings plans (*plan d'épargne action*), retirement savings plans (*plan d'épargne retraite*), employee savings plans (*plan d'épargne salariale*), or similar plans opened with a credit institution;
- deposits benefiting from the State guarantee instituted by Article 120 of Law No 2008-1443 of 30 December 2008 made on Livret A, sustainable development saving accounts (*livret de développement durable*) and social savings accounts (*livret d'épargne Populaire*);
- amounts due in representation of means of payment issued by the member credit institution, of which the beneficiary has been identified;
- the sums appearing in a customer's account in return for a loan granted by the member institution;
- for factoring operations, the overall net balance of factoring operations, taking into account the compensation and guarantee terms and conditions provided for by these contracts, is made up of the total collections on discounts left in account, minus drawings and commissions due;
- any banking product of a similar nature to those listed above.

Customers whose funds exceed these coverage limits become "creditors" of the liquidation for the amounts not compensated and may therefore be able to receive additional compensation at the end of the liquidation.

In addition, it should be noted that any sum constituting an exceptional and temporary deposit gives rise to the right to an increase in the limit of the guarantee of up to a limit of EUR500,000, for three months from the date on which it was credited to an account entering into the scope of the deposit guarantee.

**Deposits Excluded from the Scheme**
In addition, the following funds are excluded from the deposit guarantee, regardless of their holder:

- deposits the existence of which can only be proven by a financial instrument;
- deposits the principal of which is not repayable at par, or is only repayable at par by virtue of a specific guarantee or a specific agreement given by the credit institution that receives the deposits in question, or by a third party;
- deposits that have the character of own funds;
- deposits related to transactions for which a final criminal conviction for money laundering has been pronounced;
- anonymous deposits or deposits the holder of which has not been identified;
- negotiable debt securities and other debt securities issued by the credit institution.

**Funding of the Scheme**
Resources of such a Resolution Guarantee Fund are funded by contributions from its members.

The ACPR determines the modalities of calculation of the contributions of the members of the Resolution Guarantee Fund. These contributions are determined on the basis of the amount of guaranteed deposits of each member, and take into account the risk profile guaranteed to the members. The ACPR also specifies the condition under which the sums paid by the members may be refunded in the case of a decrease of the basis of their contribution. The ACPR also specifies the minimal amount due to each member.

The Resolution Guarantee Fund may borrow from its members. For that purpose, it may post or request from its members to post security contemplated by agreement.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

Under French law, bank secrecy is a professional duty applicable to the managers and employees of a credit institution in respect of information received from its clients, whereby the disclosure of any confidential information collected by the bank regarding its clients is strictly prohibited.

**Information Protected by the French Bank Secrecy**
French bank secrecy applies only to information received from clients in France and only applies to confidential data; according to French courts, protected information covers any and all information obtained by the bank within the context of professional activity and which is of a confidential nature or presents confidentiality features, such as:

- account balances, account statements, transactions carried out by a client, a list of banking products held by a client, the amount of credits granted to a client, the identity of the person who has a proxy on the account;
- the French Supreme Court held recently that the corporate name, the registration number and the head office address which identify the client of the bank as the beneficiary of a bank transfer are subject to French banking-secrecy rules;
- French courts tend to consider that certain precise data relating to persons with whom the bank does not have a contractual relationship may be confidential where such information has been collected in the context of contractual relations between the credit institution and its client;
- the French Supreme Court has on several occasions ruled that the data displayed on the back (*verso*) of a cheque, which contain information relating to the beneficiary of the cheque (name, signature, account number…) are covered by banking-secrecy rules, even though that beneficiary is not a client of the bank.

Conversely, the following data is not deemed confidential: anonymised, redacted data, general data that cannot enable the identification of a person (eg, statistics, data without any identity, etc), general assessments on the financial or economic situation of clients and information already known to the public.

**Permitted Disclosures**
The M&FC allows credit institutions to communicate confidential information to specified parties in certain circumstances; this is the concept of “shared bank secrecy” including:

- rating agencies for the purposes of rating financial products; and
- persons with whom they negotiate, conclude or execute the following transactions set out below (on a “need-to-know basis”):
  - (a) credit transactions carried out, directly or indirectly, by one or more credit institutions;
  - (b) transactions in financial, guarantee or insurance instruments intended to cover a credit risk;

(c) assignments or transfers of receivables or contracts;
(d) service contracts concluded with a third party with a view to entrusting it with significant operational functions;
(e) when reviewing or drafting any type of contract or transaction, provided that the person with whom the bank secrecy is shared is part of the same group.

The disclosure may also be permitted by the client on a case-by-case basis.

In addition, in a number of cases, bank secrecy cannot be opposed to the rules of the authorities; for instance, in a criminal proceeding (including in the case of preliminary investigations, investigations of flagrancy and letters rogatory), the judge is vested with broad powers and bank secrecy may not be used by the bank in order not to disclose certain information.

Regarding French banking and financial regulators, both the AMF and the ACPR are granted broad investigative powers by the French legislator.

When performing controls (on documents or on the spot), the controllers of the ACPR/AMF can request, verify all the books, registers, contracts or documents relating to the situation of the bank and to all transactions it carries out. They may request access to the information tools and computer data used by the bank.

The French tax administration is also vested with broad investigative powers and may require any accounting document from the bank (ie, books, registers, accounts) and any "service document" (*documents de service*) from the bank.

### Breach of Banking Secrecy

Unlawful disclosure of confidential information may result in the mere communication of the confidential data covered by professional secrecy to a third party, irrespective of the number of persons who receive such a communication (one is sufficient) and whether the disclosure is oral or written.

Violation of bank secrecy is punished by:

- criminal sanctions: one year's imprisonment and a fine of EUR15,000;
- civil sanctions: the client may engage the contractual civil liability of the bank;
- disciplinary sanctions: the ACPR may impose disciplinary sanctions to the branch and to employees of the branch.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Role of International Standards

Although the Basel Committee's recommendations are not legally binding, French banking authorities participate actively in their elaboration and ensure that credit institutions comply with Basel's different guidelines. The Basel Committee's recommendations are implemented in France through the transposition into French law of Directive 2013/36/EU on capital requirements (CRD IV), and Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms (CRR) is of direct application throughout the EU.

### Minimum Capital Requirement

The minimum paid-up capital is as follows:

- banks and mutual or co-operative banks with their head office located in France: EUR5 million;
- financing companies: EUR2.2 million (or EUR1.1 million for financing companies the sole activity of which is the granting of personal guarantees).

French SIFIs are subject to additional prudential requirements. They must comply with a systemic buffer of extra capital, to be determined by the ACPR, depending on the category of SIFI to which they belong (global systematically important institutions or other systematically important institutions).

### Risk-Management Rules for Banks

The management of a credit institution's risks are entrusted to its (Order of November 2014):

- board of directors;
- executive body with regard to the certain types of risks (for example, credit risk, market risk, global interest rate risk, intermediation risk, liquidity and settlement risk and operational risk, including internal and external fraud risk).

Solvency risk and liquidity risks are also addressed through banking ratios, in particular the capital ratios, the leverage ratio, the net stable funding ratio and the liquidity coverage ratio imposed on banks by Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR) which is part of the so-called CRD IV package, which also comprises Directive 2013/36/EU.

These ratios limit the ability of the bank to have an excessive ratio or to hold financial assets which present a high market, credit or liquidity risk.

### Main Liquidity/Capital Adequacy Requirements

The CRD IV package establishes two new liquidity buffers:

- to improve the short-term (over a 30-day period) resilience of the liquidity risk profile of financial institutions, Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms (CRR) introduced a liquidity coverage requirement (LCR);
- to ensure that a credit institution has an acceptable amount of stable funding to support its assets and activities over the medium term (over a one-year period), the CRR establishes a net stable funding requirement (NSFR) which has to be reported by the credit institutions to the ACPR, but which is not yet a binding ratio.

Financial companies (*sociétés financières*) are not required to comply with the NSFR and liquidity coverage requirement (LCR). However, they are subject to liquidity ratios tailored to their situation as entities not receiving funds repayable from the public.

### Solvency Ratio

Credit institutions are subject to a solvency ratio in accordance with the Basel Committee recommendation and Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms (CRR). Currently, credit institutions must at any time comply with an 8% ratio between the amount of their own funds and their overall credit risk exposure.

The CRR has strengthened the capital requirements by increasing the share of own funds that must be in common equity tier 1 (CET1) from 2% to 4.5%.

The CRR also established five new capital buffers: the capital conservation buffer, the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer.

In addition, supervisors can add extra capital to cover for other risks following a supervisory review, and institutions can hold an additional amount of capital on their own.

# 9. Insolvency, Recovery and Resolution

## 9.1 Legal and Regulatory Framework

### Legal Framework for Insolvency of Banks

The insolvency regime governed by the French Commercial Code offers three types of insolvency proceedings, depending on the level of financial distress:

- safeguard proceeding;
- judicial reorganisation; and
- judicial liquidation.

An additional accelerated financial safeguard proceeding has been introduced under the Law of 22 October 2010 and codified in the French Commercial Code, applying under restricted conditions (including the debtor's turnover, its number of employees and the creditor's capacity). Conciliation proceedings are also considered. More recently, the Ordinance of 12 March 2014 introduced an accelerated safeguard proceeding.

This general framework applies to credit institutions.

In addition, certain mandatory rules outlined in the Monetary and Financial Code apply to credit institutions specifically. Under these rules, proceedings are closely monitored by the ACPR. Directive 2001/24/EC on the reorganisation and winding-up of credit institutions is also implemented in the Monetary and Financial Code.

### Recovery and Resolution Regime for Banks

The Monetary and Financial Code transposes Directive 2014/59/EU, establishing a framework for the recovery and resolution of credit institutions and investment firms - bank recovery and resolution directive (BRRD). It applies to credit institutions and investment firms meeting certain conditions (Articles L. 613 to 34 et seq of the Monetary and Financial Code).

The resolution authority and the competent authority is the ACPR.

The ACPR acts within the framework of the Single Resolution Mechanism (SRM) established by Regulation (EU) 806/2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms (SRM Regulation). It must co-ordinate its resolution actions with the single resolution board established at European level (board), the Council and the Commission, under the rules and procedures defined by the SRM Regulation.

The board is considered the relevant national resolution authority (or, in the case of cross-border group resolution, the relevant group-level resolution authority) when it exercises powers which under the BRRD are exercised by the national resolution authority (SRM Regulation).

### Powers of the ACPR When the Credit Institution Is Not Subject to a Resolution Proceeding

Credit institutions established in France are subject to the supervision and control of the ACPR (Monetary and Financial Code).

However, credit institutions classified as significant are now under the direct supervision of the European Central Bank with regard to resolution, in accordance with the implementation of the European Single Supervisory Mechanism (Article 6, point 4, Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and Article 39, Regulation 468/2014 establishing the framework for co-operation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities).

The ACPR supervises compliance of credit institutions with minimum capital requirements, including prudential ratios and compliance with banking laws and regulations in general.

In the context of its control and supervisory function, the ACPR can take administrative policy measures (*mesures de police administrative*) against credit institutions under its supervision, such as:

- making recommendations to a credit institution to take appropriate measures to strengthen its financial condition, and issue injunctions requiring the institution to restore or strengthen its financial condition;
- warning a credit institution to stop certain practices that may be detrimental to its clients and that contradict the rules of good conduct applicable to credit institutions;
- designating, among others, a provisional administrator (*administrateur provisoire*) either at the request of the directors of the financial institution concerned or on its own initiative, when:
  - (a) the management of the relevant financial institution cannot be pursued under normal conditions; or
  - (b) certain key executive officers are temporary suspended.

### Early Intervention Measures

The ACPR can take early intervention measures against a credit institution where the financial situation or liquidity of the credit institution or investment firm is rapidly deteriorating and may result in the institution not complying with prudential regulations (CRR).

In these circumstances, the ACPR can require the credit institution to take several measures, such as the:

- implementation of a preventive recovery plan;
- implementation of an action plan for restructuring its debts with its creditors;
- modification of its commercial strategy;
- dismissal of the senior managers of the institution subject to resolution;
- appointment of a provisional administrator.

The ACPR can also require the institution's meeting of shareholders to convene on the basis of an agenda to be determined by the ACPR.

These early-intervention measures are adopted by the Supervision Board of the ACPR. The Supervision Board must inform the Resolution Board of measures adopted.

### Powers of the ACPR When the Credit Institution Is Subject to a Resolution Proceeding (mesures de résolution)

The ACPR can take resolution measures against a credit institution if the following conditions are met:

- the resolution board of the ACPR has determined that the credit institution is failing or likely to fail;
- there is no reasonable prospect that the failure of the credit institution may be avoided within a reasonable timeframe, other than by using resolution measures;
- a resolution action is necessary in view of the resolution objectives, and judicial liquidation proceedings provided for by Book VI of the Commercial Code would not reach these objectives to the same extent.

Under the banking resolution regime, when a credit institution is subject to a resolution process, the Resolution Board of the ACPR can take resolution measures, including:

- the appointment of a temporary administrator;
- the ability to use a bridge bank, in whole or in part, in relation to any activity branches of the credit institution subject to the resolution proceeding, with a view to sale at a later stage;
- the sale of assets (transfer of one or several branches of activity);
- the creation of an asset separation tool;
- bail-in measures; that is, the reduction or cancellation of the debt, or the conversion of debt into equity or securities assimilated to equity, to absorb the amount of depreciation). The ACPR can apply these measures as a matter of principle to all the liabilities of a credit institution or an investment firm under resolution. However, the ACPR cannot exercise write-down or conversion powers in respect of secured liabilities, including covered bonds and liabilities in the form of financial instruments used for hedging purposes, which:
  - (a) form an integral part of the cover pool; and
  - (b) according to national law are secured in a way similar to covered bonds.

The Resolution Board of the ACPR can take additional resolution measures, including to:

- suspend payment or delivery obligations under any contract;
- restrict the enforcement of security interests;
- temporarily suspend contractual termination rights.

These measures are in force from the publication of a notice of the suspension until midnight at the end of the business day following that publication.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

The main upcoming regulatory developments which can be expected in France relate to the opportunities raised by the digital revolution and financial services innovation.

The transmission of financial securities on a Distributed Ledger Register could bring modernity in the recording of securities of small and mid-cap companies where old-fashioned paper records still prevail.

Cryptocurrencies could also see some major changes with the development of governmental-led projects. France has also enacted a simple and attractive regime, both for initial coin offerings (ICOs) and DASPs.

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**De Pardieu Brocas Maffei** is one of the leading Paris-based business law firms with an international reach, with 150 lawyers, including 33 partners. Its teams have the capabilities to support clients in France and internationally in the principal areas of business law. The firm is widely recognised for its strong expertise in financing transactions, real estate investment, M&A and private equity, and offers assistance in tax, employment, competition and public law. The regulatory team advises banks, investment firms, foreign funds, insurance companies, fintechs and payment service providers on all French financial regulatory aspects. Within the banking and finance team, its lawyers combine an in-depth knowledge of financial regulations with a wealth of experience of financial transactions. Recent achievements of the regulatory team include advising a UK-based insurance company on the acquisition of a French brokerage and services provider, representing a leader in consumer credits on the negotiation of partnership agreements with French retailers, and advising foreign investment funds on the conduct of lending activities in France.

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# Trends and Developments

***Contributed by:***
*Olivier Hubert, Corentin Coatalem and Arnaud Pince*
***De Pardieu Brocas Maffei see p.73***

### The Impact of the COVID-19 Pandemic on Banking Regulation

Not surprisingly, the 2020 agenda of banking and finance reforms has been somewhat disrupted by the COVID-19 Pandemic. The French government's top priorities shifted to the preservation of economic activities and the preparation of an ambitious recovery plan, both at European and French levels. Lending activities have been stimulated by a broad use of bridge loans guaranteed by the French State and by deferral of payments.

Financial stability concerns may well resurface at the forefront of supervisors' concerns; it can be reasonably expected that the crisis will cause a significant increase in non-performing loans and financial losses for the banking sector. It will also be a test case for prudential rules imposed during the years 2000 to 2010; in any case, the authorities are unlikely to relax the ratios and capital requirements of banking institutions.

### Digitalisation

Digitalisation is also a prominent winner in this crisis. As a consequence, business and financial activities which are not yet digitalised appear to be a potential area of weakness in the general organisation; as a result, the processing of business transactions has had to adapt, including the signature, payment and identifications processes aimed at the fight against money laundering.

France is determined to seize the opportunities raised by the digital revolution and stands at the forefront of financial services' innovation. Recently, France introduced pioneer legislation on the representation and transmission of financial securities on a Distributed Ledger Register. Further, French accounting rules were modernised to integrate the accounting treatment of tokens.

France has also enacted a simple and attractive regime for both Initial Coin Offerings (ICOs) and Digital Assets Service Providers (DASPs).

The control functions of banks could draw further benefits from digital transformation, according to a recent Prudential and Resolution Control Authority (*Autorité de Contrôle Prudentiel et de Résolution*) (ACPR) report. The potential of regulatory technology (RegTech) in terms of control and risk management is intriguing; currently, the main RegTech opportunities identified by the banks are in the following areas:

- anti-money laundering and counter-terrorist financing systems for "Know Your Customer" programmes, particularly during the first remote contact with customers (by mobile or internet);
- an operational and compliance-risk control system is also using digital transformation, especially in combating fraud, both internally and externally, thanks to the expanded use and cross-referencing of data (payment means fraud, fraudulent trading, and so on).

New technologies could also help institutions to identify and accept new regulatory standards and their impacts.

The implementation of the benchmark Regulation (EU) 2016/1011 of 8 June 2016 is on its way; interbank rates will progressively disappear and leave the stage to new, alternative, risk-free rates. The transition appears less difficult for the Euro indices (which will remain, but will be calculated by a different method) and other Interbank-offered (IBOR) rates, which will be replaced by new indices. The derivative industry (International Swaps and Derivatives Association – ISDA), the Federation Bancaire Française and the loan market association have made available to market players contractual documentation which allows both the continuation of existing contracts and the implementation of revised fall-back provisions.

### Terrorism and Money Laundering

The fight against terrorism and money laundering remains a priority for French regulators; the burden of due diligences and follow-up duties imposed by the LCB-FT regulations is increasing and ACPR sanctions against banks and investment service-providers who improperly apply the rules are becoming more and more frequent. Obligations of credit institutions will also be reinforced, in particular the due diligence measures to be implemented for business relations or transactions related to high-risk third countries with the adoption of the Fifth Money Laundering Directive ((EU) 2018 /843) (MLD5 or 5MLD).

Credit institutions are increasingly constrained to take part in the fight against tax fraud, as they are now required to declare cross-border transactions which are tax-motivated or which may have a potential tax effect. This is a result, in particular, of the adoption of Directive 2018/822 of 25 May 2018, known as DAC 6, which was implemented under French law by Ordinance No 2019-1068 of 21 October 2019, on the automatic and mandatory exchange of information in the field of tax. In addition, the cost of tax evasion for the government has led to crackdowns against private banking institutions which assisted in tax evasion. In this respect, a landmark decision was rendered in banking litigation with the UBS case, where UBS AG was found guilty of unlawful solicitation of clients on French territory and of having helped them to implement tax-evasion schemes. The French branch of UBS was also found guilty of complicity in the same illegal actions.

### The Potential Impact of Brexit

The potential occurrence of a no-deal Brexit is also a source of concern for EU credit institutions; such a scenario would oblige banks to amend a certain number of contracts that have been entered into with British counterparties. In a number of activities, the UK will become a third country and major consequences are expected in the field of fund management and cross-border financial services, even if a number of preparatory steps have been taken, for instance, in order to secure mutual recognition of payment and clearing systems.

In fund management activities, 2020 should be a landmark year, with the publication of the implementation of legal and tax rules applicable to financing entities (*Organismes de Financement*), a new type of multi-purpose and flexible regulated fund which offers a competitive framework to investment activities in Europe.

**De Pardieu Brocas Maffei** is one of the leading Paris-based business law firms with an international reach, with 150 lawyers, including 33 partners. Its teams have the capabilities to support clients in France and internationally in the principal areas of business law. The firm is widely recognised for its strong expertise in financing transactions, real estate investment, M&A and private equity, and offers assistance in tax, employment, competition and public law. The regulatory team advises banks, investment firms, foreign funds, insurance companies, fintechs and payment service providers on all French financial regulatory aspects. Within the banking and finance team, its lawyers combine an in-depth knowledge of financial regulations with a wealth of experience of financial transactions. Recent achievements of the regulatory team include advising a UK-based insurance company on the acquisition of a French brokerage and services provider, representing a leader in consumer credits on the negotiation of partnership agreements with French retailers, and advising foreign investment funds on the conduct of lending activities in France.

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# GREECE

## Law and Practice

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## Contents

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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

Banking supervision in Greece is regulated by the Single Supervisory Mechanism (SSM) which was established under EU Regulation 1024/2013. This Regulation confers powers on the European Central Bank (ECB) for the prudential supervision of credit institutions. Its operational framework is specified by Regulation 468/2014 establishing the framework for co-operation between the ECB, national competent authorities, and national designated authorities within the SSM.

Under the above regulatory framework, the ECB has undertaken the direct prudential supervision of banks established in the eurozone and classified as significant, while the remaining institutions are supervised by national competent authorities under ECB guidance. The following Greek banks are subject to direct supervision by the ECB, in co-operation with the Bank of Greece (BoG):

- Alpha Bank SA;
- Eurobank SA;
- National Bank of Greece SA; and
- Piraeus Bank SA.

Smaller institutions are subject to the prudential supervision of the BoG, which seeks to protect the soundness, financial health and stability of the financial system and ensure that banks do not undertake excessive risks that may endanger their performance. Prudential supervision includes assessing the solvency and liquidity of the banks, as well as the strategies, internal procedures and mechanisms implemented thereby to ensure compliance with the above EU regulatory framework as well as Law 4261/2014 (the Banking Law). It also monitors compliance with Regulation 575/2013 (CRR) and Level 2 measures on regulatory reporting, capital adequacy and liquidity requirements.

Moreover, in accordance with Law 4557/2018 as amended by Law 4734/2020, implementing Directives 2015/849 and 2018/843 on the prevention and control of money laundering and terrorist financing (the AML/CTF Law), the BoG is appointed as the competent authority for the supervision of compliance with AML/CFT provisions.

Finally, the Hellenic Capital Market Commission (HCMC) undertakes supervision of Greek banks with regard to the provision of investment services and related activities as well as compliance with requirements of Law 4514/2018, implementing the MiFID II Law. Furthermore, HCMC is the competent authority for market abuse for Greek banks with listed shares pursuant to the Market Abuse Regulation (Regulation 596/2014) and Law 4443/2016.

The core legal and regulatory framework governing the operation of banks in Greece comprises the following:

- SSM Regulation;
- SSM Framework Regulation;
- Single Resolution Mechanism;
- CRR;
- *Sociétés Anonymes* (SAs) Law (Greek Law 4548/2018) — the predominant legal structure of banks established and operating in Greece;
- Banking Law; and
- relevant acts issued by the BoG. Said BoG acts consist of BoG Governor's Acts, BoG Executive Committee Acts, BoG Banking and Credit Committee Decisions and BoG Credit and Insurance Committee Decisions. They regulate the granting of banking licences, internal control systems and corporate governance issues, obligations arising from the AML/CTF Law, reporting obligations and transparency in banking transactions.

The following EU and Greek pieces of legislation supplement the core legal and regulatory framework described above:

- Directive 2014/59 (bank recovery and resolution or BRRD), transposed by Greek Law 4335/2015 (the BRRD Law);
- Directive 2014/49 (on deposit guarantee schemes), transposed by Greek Law 4370/2016;
- Financial Action Task Force (FATF) recommendations and the relevant EU legal framework;
- Greek Law 4537/2018, implementing Directive 2015/2366 (the PSD II Law); and
- the MiFID II Law.

# 2. Authorisation

## 2.1 Licences and Application Process

Banks established and operating in Greece must be authorised by the BoG. Since 4 November 2014, all banks need authorisation from the ECB to operate in a member state which is part of the SSM, as is Greece. Natural or legal persons that are not qualified as credit institutions are prohibited from taking deposits or other repayable funds from the public.

In particular, Greek banks may be established and operable as: (a) SAs; (b) credit co-operatives; (c) European companies (*societas Europaea*); or (d) European co-operative societies. Greek SA banks — the predominant legal structure of banks established and operating in Greece — adhere to SA regulations, while banks in the form of credit co-operatives are regulated by Law 1667/1986. Moreover, banks may be licensed to perform all banking activities listed in Annex I of the CRD IV. These activities include:

- acceptance of deposits or other repayable funds;
- lending or granting of other credits including consumer credit, credit agreements relating to immovable property, factoring, with or without recourse, financing of commercial transactions (including forfeiting);
- financial leasing;
- payment services as defined in Article 4(3) of the PSD II Law;
- issuing and administering other means of payment (ie, travellers' cheques and bankers' drafts) insofar as such activity is not covered by the above point;
- guarantees and commitments;
- dealing on its own account or on account of customers in any of the following:
  (a) money market instruments (cheques, bills, certificates of deposit, etc);
  (b) foreign exchange;
  (c) financial futures and options;
  (d) exchange and interest-rate instruments;
  (e) transferable securities;
  (f) participation in securities issues and the provision of services relating to such issues, in particular underwriting;
  (g) advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings;
  (h) money broking;
  (i) portfolio management or advice;
  (j) safekeeping and administration of securities;
  (k) credit reference services, including customer credit rating;
  (l) safe custody services;
  (m) issuing electronic money; and
  (n) investment services and activities as well as ancillary services provided for in the MiFID II Law.

The BoG may, in addition to the activities described in Annex I of the CRD IV, allow banks to carry out other financial or secondary activities, according to the applicable legislation, provided that the relevant risks are fully hedged.

In addition, a credit co-operative may conduct banking transactions solely with its members, other banks and the government. Subject to prior approval by the BoG, it may also carry out banking transactions with non-members, with a maximum amount allowed of 50% of its total loan or deposit business.

Licensing requirements include:

- full pay up the (i) initial capital equal to at least EUR18 million or EUR9 million in the case of third country branches, or EUR6 million in the case of banks and credit co-operatives licensed as banks, as well as (ii) any additional funds that may be required in order to ensure that, during its first three years in operation, the new bank's own funds meet the expected capital requirements and the minimum initial capital on a continuous basis;
- at least two persons effectively directing the bank's business and participating as executive members of its board of directors (BoD);
- Greek banks need to have both their head office and registered office in Greece; and
- compliance with conditions for participation in the Hellenic Deposit and Investment Guarantee Fund (TEKE).

Licensing applications are exclusively submitted to the BoG which, via the provisions of the BoG Executive Committee's Act 142/11.06.2018 as recently amended by BoG Executive Committee's Act 178/2.10.2020, determines the contents thereof, the documentation and information required, the specific conditions and the licensing procedure to be followed. Where the BoG assesses that the legal conditions for licensing under the Banking Law are met, it proceeds to the submission of a proposal in the form of a draft licensing decision to the ECB. Alternatively, if per the BoG assessment the respective requirements are not met, the BoG rejects the licensing request. Unless the ECB objects, the BoG proposal is deemed to be adopted.

Applications for licensing must, inter alia, be accompanied with:

- a schedule of operations setting out the types of business envisaged and the bank's structural organisation;
- information about the heads of the critical functions, including their identity, reputation, education, any criminal convictions, property, experience and training;
- details of the bank's main operational and organisational arrangements (namely, the scope of business, time schedule for achievement of objects, group structure if applicable, as well as the structure of its internal control system, including the internal audit, risk management and compliance functions and procedures required for compliance with its organisational obligations); and
- draft Articles of Association (AoA).

### Time and Cost Estimation

Where the BoG rejects a licensing application, it notifies the applicant of its decision,and the reasons thereof, within six months of its receipt. Where the application file is incomplete, the applicant must provide the missing information within twelve months from when the BoG receives the information. In any case, under the Banking Law a decision to grant or refuse licensing may be taken within 12 months from the receipt of the application.

Save for legal fees, or fees paid for advisers (ie, tax or finance), no statutory/regulatory fees are required for the submission of the respective licensing application to the BoG.

With regard to the establishment of EU or EEA-licensed banks, the Banking Law has fully implemented the single passport principle. Therefore, said banks that are licensed in their home member states may perform banking activities in Greece, either through an establishment or on a cross-border basis, subject to relevant notification sent to the BoG by the home member state regulator.

Finally, with respect to non-EU or non-EEA-licensed banks, pursuant to the Banking Law in conjunction with the MiFID II Law, such institutions may carry out banking activities in Greece, either through an establishment or on a cross-border basis, subject to obtaining a licence by the BoG. In such case, the provisions of BoG Executive Committee's Act 58/18.1.2016 regarding the establishment and operation of branches of credit institutions established in third countries shall apply.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

The terms and conditions for the acquisition or increase or decrease of a qualifying holding in a bank (ie, a direct or indirect holding in an undertaking which represents 10% 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) are laid down in the Banking Law, and are further specified in BoG Executive Committee's Act 142/11.6.2018 (as amended by BoG Executive Committee's Act 178/2.10.2020) and Banking and Credit Committee's Decision 211/1/5.12.2005.

In particular, any natural person or legal entity deciding to directly or indirectly acquire or increase a qualifying holding in a bank, as a result of which either the proportion of the voting rights or the capital held would reach or exceed the thresholds of 20%, 50% or one-third, or so that the bank would become its subsidiary, must pre-notify the BoG in writing, indicating the size of the intended holding and the fulfilment of the conditions required by the BoG.

Under the Banking Law, pre-notification to the BoG is also required in case of an acquisition of a holding amounting to at least 5%. However, in this case the BoG will assess – within five working days – whether the holding will lead to a significant influence over the bank and, if so, will notify the proposed acquirer and conduct an assessment on the conditions required for the acquisition.

On assessment of the proposed acquisition, the BoG will prepare a draft decision for the ECB to oppose or accept, based on specific criteria. If the ECB does not oppose the intended acquisition within 60 days, it will be deemed approved.

In principle, the applicable regulatory process does not distinguish between a Greek and foreign acquirer, except for in:

- the extension of the assessment period to a total of 90 days, where the BoG requests additional documents from a proposed acquirer being situated or established in a third country or not subject to supervision under the CRD IV, the MiFID II, the EU Solvency II Directive (2009/138/EU), the EU Undertakings for the Collective Investment in Transferable Securities Directive (2009/65/EU); and
- the co-operation between the BoG and the national competent authorities of a foreign proposed acquirer.

In order to ensure the sound and prudent management of the bank in which the acquisition is proposed, the BoG will review the notification and all information provided, assess the suitability of the proposed acquirer and the financial soundness of the proposed acquisition and consider:

- the reputation and reliability of the proposed acquirer;
- the reputation, knowledge, skills and experience of the proposed new directors and key function holders;
- the financial soundness of the proposed acquirer;
- whether the bank will be able to comply with its prudential supervision obligations on a continuing basis; and
- whether there is any risk deriving from the proposed acquirer being tied to any money laundering or terrorist financing activities.

The proposed acquirer must accompany notification to the BoG with specific questionnaires and supporting documentation specified in the BoG Executive Committee's Act 142/2018 as amended by BoG's Executive Committee's Act 178/2.10.2020.

## 4. Supervision

### 4.1 Corporate Governance Requirements

The corporate governance regime applicable to banks is primarily set out in the Banking Law and supplemented by the BoG Governor's Act 2577/2006, as in force. In terms of Greek banks whose shares are listed for trade on the Athens Stock Exchange, Law 3016/2002 on corporate governance of listed companies also applies, while the *Sociétés Anonymes* Law supplements the regulatory and corporate legal framework.

Pursuant to the Banking Law, banks are required to have:

- robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility;
- effective processes to identify, manage, monitor and report the risks they are or might be exposed to;
- adequate internal control mechanisms, including sound administration and accounting procedures;
- remuneration policies and practices that are consistent with and promote sound and effective risk management; and
- recovery plans.

Such arrangements, processes and mechanisms must be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the bank's activities.

Along with the Banking Law, BoG Governor's Act 2577/2006 sets out the minimum corporate governance requirements that all banks should satisfy. In particular:

- the BoD consists of executive and non-executive members, out of whom at least one should be a non-executive and independent member;
- subject to the bank's size and the complexity of its activities, the BoD is assisted by the internal audit committee, the risk management committee, the remuneration committee and other ad hoc committees (such as the nomination committee); and
- the following units, which are independent from one another, should be established:
    (a) an internal audit unit that reports to the internal audit committee;
    (b) a risk management unit that reports to the risk management committee and the BoD; and
    (c) a compliance unit that is subject to control by the internal audit unit; the compliance manager may be also appointed as AML officer.

In addition, pursuant to BoG Governor's Act 2577/2006, each bank should have an organisational structure and processes that ensure:

- the appointment of officers authorised to communicate with the BoG and other authorities;
- crisis management;
- a business continuation (COB) plan;
- direct or indirect involvement of at least two employees in each activity (four eyes principle);
- separation of the duties and operations of the front line from the back office;
- the involvement of the internal audit, compliance and risk management units in each product programme or significant business decision;
- financing of BoD members or general managers on an arm's-length basis; and
- appointment of external auditors for the assessment of the internal audit system at least once every three years.

With regard to outsourcing requirements, the BoG recently issued Executive Committee's Act 178/5/2.10.2020, adopting the guidelines of the European Banking Authority (EBA) on outsourcing arrangements and abolishing the existing framework for outsourcing, laid down in Annex 1 to BoG Governor's Act 2577/9.3.2006.

Under the new framework, banks are required to inform the BoG of their intended arrangements for the outsourcing of critical or important functions before they enter into any outsourcing agreement, but without the need for a relevant BoG approval. However, where it is judged that the relevant supervisory requirements are not met, the BoG may decide not to allow the outsourcing of functions or may request the termination of any outsourcing agreement in force.

Furthermore, banks are obliged to maintain a register of information on all outsourcing agreements, which shall be made available to the BoG, upon request, along with any other information necessary for the exercise of effective supervision.

## 4.2 Registration and Oversight of Senior Management

### BoD and Key Function Holders Regulatory Approval – Fit and Proper Assessment

BoD members as well as holders of a bank's key functions are required to be of good reputation and to have adequate knowledge, skills and experience to be able to understand the bank's activities, including the main risks, and to act with honesty, integrity and independence.

To that end, pursuant to the BoG Executive Committee's Act 142/11.6.2018 as amended by the BoG Executive Committee's Act 178/2.10.2020, in cases of the appointment of a new BoD member, a key function holder or a AML/CTF Officer, the bank must notify the BoG in writing, completing and submitting the Annex II questionnaire: "Fit and proper assessment of members of the board of directors and key function holders". The "fit and proper" assessment focuses on the suitability of the new appointed persons in relation to their duties, as well as their professional or family relations. This procedure does not replace the bank's primary obligation to recruit competent and suitable executives.

If the persons to be appointed have already undergone a fit and proper assessment by the BoG or another supervisory authority, in connection with duties related to regulated activities of the financial sector in accordance with EU or other equivalent law, the BoG may waive the assessment and simply require notification of the identity of either such persons or simply the regulated legal person, reserving the right of consultation with the relevant supervisory authority.

Following their approval by the BoG, the BoD members are elected by the bank's General Meeting of the Shareholders pursuant to the provisions of the *Sociétés Anonymes* Law, and their tenure cannot exceed six years.

#### BoD's Roles and Accountability

The BoD defines, oversees and is accountable for implementing the governance arrangements ensuring the bank's effective and prudent management. To avoid any cases of conflicting interests, the BoG deems it necessary for banks to adopt the international best practices and principles of corporate governance, particularly in respect of segregation of executive and supervisory functions of BoD members, including the segregation of the BoD chairman's functions from the CEO's executive functions.

The BoD is responsible for the consistent implementation of the following, among others:

- the bank's strategic orientation, the reassessment thereof, and adoption of suitable policies aiming at ensuring an adequate and effective internal control system;
- the adoption of a suitable risk management policy, specifying the maximum risk exposure limits acceptable from time to time, as well as a regulatory compliance policy;the adoption of a Code of Ethics complied with by the bank's management and its overall staff, on the basis of generally acceptable standards;
- the accuracy of the financial statements annually and periodically published by the bank and its group (if any), as well as the accuracy of the data submitted to the BoG and other regulatory authorities; and
- the bank's operation in compliance with the legal framework, its internal regulations and corporate governance principles, taking the appropriate measures regarding the selection and replacement, if needed, of officers in key positions.

### 4.3 Remuneration Requirements

The Banking Law requires banks to have remuneration policy applying to the BoD members. Such provisions are further supplemented by the *Sociétés Anonymes* Law as well as the BoG Governor's Act 2650/2012. Pursuant to such provisions, the remuneration policy must be in line with the business strategy, objectives, values and long-term interests of the bank, and must incorporate measures to avoid conflicts of interest.

The non-executive BoD members must adopt and periodically review the remuneration policy and are responsible for overseeing its implementation, which must be reviewed at least annually by the bank's internal audit unit.

Furthermore, staff engaged in control functions must be remunerated in accordance with objectives linked to their functions, independent of the performance of the business areas they control, while remuneration of senior officers in the risk management and compliance functions must be directly overseen by the remuneration committee or by the non-executive BoD members.

The remuneration policy must clearly distinguish between criteria for setting basic fixed remuneration and variable remuneration, taking into account national criteria on wage setting.

Banks must provide the BoG with information on remuneration, including the number of natural persons per institution that receive EUR1 million or more per financial year.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

Banks must comply with the applicable AML/CTF framework, namely the AML/CTF Law, BoG Banking and Credit Matters Decision 281/17.03.2009 (the AML/CTF Decision), FATF Recommendations including FATF Report on Covid-19-related AML/CTF Risks and Policy Responses, EBA's guidelines and, finally, ministerial decisions, including the decision on the establishment of the National Beneficial Owners Registry.

AML/CTF requirements include validating the transaction and identifying the parties thereof to eliminate suspicions of questionable conduct or unknown, untraceable origins of assets. For this purpose, banks must establish appropriate AML/CTF policy and IT systems for the ongoing monitoring and detection of suspicious or unusual transactions and activities.

In view of the above, banks must apply due diligence measures to new and existing clients, high-risk individuals, Politically Exposed Persons (PEPs) and transactions executed without the client's physical presence, among others. In principle, requirements of due diligence apply:

- when carrying out an occasional transaction amounting to EUR15,000 or more, or in cases where the transaction constitutes a transfer of funds exceeding EUR1,000;
- in the case of persons trading in goods, when carrying out occasional transactions in cash amounting to EUR10,000 or more, whether the transaction is carried out in a single or several operations that appear to be linked;
- when there is a suspicion of money laundering or terrorist financing, regardless of any derogation, exemption or threshold;
- when there are doubts about the veracity or adequacy of previously obtained data for the certification and verification of the customer or beneficial owner's identity; and
- for electronic money or special prepaid instruments with a maximum payment transactions limit exceeding EUR150 in both cases.

Banks must assess the business relationship and continue to monitor on an ongoing basis, including scrutinising transactions, acting on the basis of risk assessment. Enhanced due diligence measures also apply when dealing with natural or legal persons established in the third countries identified by the European Commission as high-risk third countries as well as to transactions or business relationships with PEPs. In order to meet the due diligence requirements, banks are permitted to rely on third parties. Due diligence records must be kept for five years after the end of the business relationship with the client or five years from the date of a transaction.

When identifying a suspicious transaction, banks must:

- immediately report such transaction to the AML/CTF Authority (FIU);
- immediately provide all information requested by the FIU or other supervising authorities; and
- abstain from informing the client or any third party either that they have filed a report of a suspicious transaction or that they have received a request to provide information to any investigating authority.

Administrative sanctions are imposed in the event of a breach of AML/CTF obligations, including fines, cessation of business activities, suspension or withdrawal of operating licences and public announcement. The fine imposed may amount up to EUR5 million while an additional fine of up to EUR5 million may be imposed on BoD members, managing directors, managers or other employees.

To ensure compliance, the appointment of an AML/CTF Officer is required. Moreover, allocation of responsibilities and duties to the persons and units involved in the bank's transactions and operations must be clear in order to ensure effective implementation of AML/CFT policy, procedures and controls and achieve compliance with the AML/CTF framework.

AML/CTF obligations, with respect to a parent credit institution, are performed by both its subsidiaries in Greece and abroad, and its branches and representative offices abroad, unless this is wholly or partly prohibited by the relevant foreign legislation, in which case FIU and the BoG must be notified.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

#### Administration of the Hellenic Deposit and Investment Guarantee Fund (TEKE)

TEKE is the operator of the deposit guarantee and investment compensation schemes and the Resolution Fund for banks. TEKE is governed by Law 4370/2016 and is supervised by the Greek Ministry of Finance (MoF).

TEKE is responsible for:

- paying compensation to depositors in the event that deposits become unavailable;
- paying compensation to investor clients of banks when the latter become unable to fulfil their obligations towards them; and
- financing resolution measures applied to banks.

TEKE is composed of three separate schemes:

- the Deposit Cover Scheme (DCS) for coverage of depositors;
- the Investment Cover Scheme (ICS), for coverage of investor clients; and
- the Resolution Scheme (RS), for the financing of resolution measures.

DCS, ICS and RS are clearly distinct from each other and are separate property groups, each being solely earmarked for its respective purpose and serving such purpose in accordance with the provisions of the legislation in force.

Coverage by DCS is compulsory for:

- all Greek banks;
- foreign branches of Greek banks; and
- domestic branches of banks incorporated outside the EU.

It should be noted that branches of banks incorporated in another EU member state do not participate in TEKE, as they are covered by the Deposit Guarantee Scheme of the respective country in which their registered office is located (home member state).

**DCS Funding**
An initial contribution is required from banks joining the DCS and is payable within one month of the date on which they become members. New entrants in the DCS pay the initial contribution in three annual instalments by crediting the dedicated DCS account with the BoG. Regular contributions are paid annually. The key factors considered in the calculation of the annual regular contributions are the amount of covered deposits and the degree of risk assumed by each bank.

Extraordinary contributions are paid in the event that the available DCS funds are not sufficient to compensate depositors. Extraordinary contributions must not exceed 0.5% of the covered deposits of each bank per calendar year. In exceptional circumstances, higher contributions may be specified by decision of TEKE's BoD with the consent of the BoG.

***Extent of coverage under DCS***
DCS covers deposits held by natural persons or legal entities, irrespective of the currency, such as:

- savings accounts;
- sight deposits;
- current accounts; and
- time deposits.

However, the following deposits are excluded from DCS coverage:

- deposits made by other banks on their own behalf and for their own account;
- banks' own funds;
- deposits arising out of transactions in connection with which there has been a criminal conviction for AML/CTF; during the criminal proceedings, any compensation is suspended, until a final court ruling;
- deposits by financial institutions;
- deposits by investment firms on their own behalf and for their own account;
- deposits the holder or beneficiary of which has never been identified;
- deposits by insurance and reinsurance undertakings;
- deposits by collective investment undertakings;
- deposits by social security and occupational pension funds;
- deposits by public authorities as defined in Law 4270/2014;
- debt securities issued by a bank and liabilities arising out of own acceptances and promissory notes; and
- deposits by TEKE.

Compensation is paid in euro to beneficiaries of Greek banks and, with respect to depositors in foreign branches, in the currency of the country where the account is held.

The maximum level of coverage is EUR100 per depositor per bank (unless there is a case of additional coverage) for the total amount of their deposits, regardless of the number of accounts, including interest accrued by the date on which the deposit becomes unavailable. The reference date for the calculation of the repayable amount is the date on which the deposit becomes unavailable.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements
As regards banking secrecy and confidentiality, any information, data and transactions pertaining to a client's banking relationship are of a confidential nature and subject to a general professional duty of confidentiality. These confidentiality obligations of general application derive from the general duties of loyalty and confidentiality that banks owe to their clients. Secrecy restrictions arising from this general duty of confidentiality may be waived with the client's consent or approval to the extent that the relevant information does not relate to cash/securities deposits. While there are no specific rules that define such general duties of confidentiality on any banking transaction, deposits of any kind (both cash and securities) enjoy a higher degree of protection. As regards the latter, Greek legislation has followed a stricter approach, prohibiting disclosure in any manner by threatening criminal sanctions in case of violation.

In particular, the Greek Bank Secrecy Law (Legislative Decree 1059/1971) covers deposits of any kind (cash and securities) prohibiting disclosure of deposit-related information to third parties, even if the holders of the respective accounts have given their consent. The Greek Bank Secrecy Law applies to all banks operating in Greece, including foreign banks operating through a local establishment.

Banking secrecy obligations do not apply towards the BoG and solely for the purpose of exercising its competencies related to the banking supervision/regulation and to the implementation of monetary, financial and foreign currency rules. Moreover, banking secrecy is lifted in cases explicitly provided for in the law (eg, tax evasion).

The obligation to keep the confidentiality of deposits is imposed primarily over the persons who have access to clients' accounts when performing their duties or assignments. In compliance with the generally acceptable principle of proportionality, these persons should not obtain more information than is actually needed in order to perform their duties. Any unnecessary disclosure such as granting access to persons with duties not related to the bank accounts should be avoided even within the operation and structure of a banking organisation.

Any breach may result in imprisonment for at least six months and civil liabilities towards the relevant account holders may be invoked. Authorisation or approval by the depositor benefiting from a bank's secrecy obligation does not revoke the punishable nature of the disclosure of information on deposits.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Capital Adequacy

The CRR and the CRD IV implementing the Basel III global regulatory standards on capital adequacy and liquidity provide the vast majority of the capital adequacy requirements applicable to banks. Specific liquidity requirements may be imposed by the BoG if considered necessary. There is a leverage ratio applicable to all banks which is calculated in accordance with the methodology set out in Article 429 of the CRR. Moreover, CRD IV provides for controls related to the measurement, monitoring and management of undertaken risks, coupled with detailed disclosure requirements (Pillar III). Within this framework:

- emphasis is given to Common Equity Tier 1 (CET 1) capital;
- the following capital adequacy minimum requirements are defined:
- for the CET 1 ratio, a minimum threshold of 4.5%;
- for the Tier 1 ratio, a minimum threshold of 6%;
- for the Total Capital ratio, a minimum threshold of 8%;
- banks maintain capital buffers comprising of CET 1 capital;
- banks monitor credit valuation adjustment (CVA) risk and maintain adequate capital;
- banks monitor central counterparty (CCP) risk;
- banks calculate a leverage ratio, for monitoring excessive leverage; and
- banks calculate a Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) for monitoring liquidity risk.

On top of the above requirements, the Banking Law (Articles 121-130) has, following Basel III, introduced the necessary capital buffers.

More specifically:

- a capital conservation buffer equal to 2.5% of total risk exposure amount calculated in accordance with Article 92(3) of the CRR;
- an institution-specific countercyclical capital buffer of an amount calculated in accordance with Article 92(3) of the CRR multiplied by the weighted average of the countercyclical buffer rates; and
- a systemic risk buffer of CET 1 of at least 1% based on the exposures to which the systemic risk buffer applies can be introduced by the BoG for the financial sector or one or more subsets of that sector, in order to prevent and mitigate long-term non-cyclical systemic or macro-prudential risks not covered by the CRR.

For systemically important banks (SIFIs), each global SIFI (G-SII) must on a consolidated basis maintain a buffer corresponding to one of five sub-categories to which the G-SII is allocated by the BoG and which consists of CET 1 in addition to:

- the own funds requirement under CRR (Article 92);
- the capital conservation buffer requirement;
- any own funds requirement; and
- any institution-specific countercyclical capital buffer requirement (currently set at 0% for the fourth quarter of 2020 per BoG Executive Committee's Act 177/2/16.09.2020).

Each other SIFI (O-SII) may be required by the BoG, on a consolidated or sub-consolidated or individual basis, to maintain an O-SII buffer of up to 2% of the total risk exposure amount calculated in accordance with the CCR (Article 92).

Where an O-SII is a subsidiary of either a G-SII or an O-SII which is an EU parent institution and subject to an O-SII buffer on a consolidated basis, the buffer that applies at individual or sub-consolidated level for the O-SII must not exceed the higher of:

- 1% of the total risk exposure amount calculated in accordance with CCR (Article 92); and
- the G-SII or O-SII buffer rate applicable to the group at a consolidated level.

Notwithstanding the above, in March 2020 the ECB announced, in a press release, a number of measures that temporarily permit the banks directly supervised by the ECB to deviate from the above — described as capital adequacy requirements, and due to the COVID-19 crisis. Pursuant to said announcement, banks may temporarily operate below the level of capital defined by the Pillar II guidance, the capital conservation buffer and the liquidity coverage ratio. Banks may also partially use capital instruments that do not qualify as CET 1 capital in order to meet Pillar II requirements.

In addition, the Banking Law requires a minimum paid-up initial capital of:

- EUR18 million for Greek banks;
- EUR9 million for branches of third-country banks; and
- EUR6 million for Greek credit co-operative banks.

These thresholds may be adjusted by the competent authority to amounts of no less than EUR5 million.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

On 23 July 2015, BRRD was transposed into Greek law and came into force by virtue of the BRRD Law.

The BRRD is part of the Single Rulebook ie — the CRR, CRD IV, the BRRD and Directive 2014/49/EU (Deposit Guarantee Schemes Directive or DGSD) — which sets a uniform regulatory framework for credit and financial institutions operating in the EU for the purpose of completing the single market in financial services. Specifically, BRRD governs the EU financial services market and establishes a reference framework for the recovery and resolution of credit institutions and investment firms.

#### Designation of National Resolution Authorities and Funds

The national resolution authorities designated by virtue of the BRRD Law are the BoG, with respect to credit institutions, and the HCMC with respect to investment firms.

The Resolution Scheme of TEKE is designated as the national resolution fund for ensuring the effective implementation of the resolution tools in respect of banks. As far as investment firms are concerned, the respective functions are performed by the Athens Stock Exchange Members' Guarantee Fund.

The national resolution authorities are granted with a wide range of resolution powers, including the power to request from all supervised institutions any available information, to carry out dawn raids and to impose fines and administrative sanctions. In discharging their duties, the national resolution authorities will work further in close co-operation with their counterparts at EU level, namely the Single Recovery Mechanism and the Single Recovery Fund.

In deviation from the provisions of BRRD, the consent of the MoF is required for the exercise of various powers delegated to the national resolution authorities (including giving effect to the bail-in tool).

#### Resolution Measures

Pursuant to the BRRD Law, with respect to Greek banks, the BoG has been designated as the national resolution authority, and the Resolution Scheme of TEKE as the national resolution fund.

The powers provided to the said competent Greek authorities are divided into three categories:

- preparation and prevention with preparatory steps such as recovery plans, while the BoG prepares a resolution plan for each bank;
- early intervention with predetermined measures at an early stage so as to avoid insolvency; and
- resolution, if insolvency of an institution presents a concern with regard to general public interest.

In the context of the BRRD Law, the BoG has the power to apply a set of resolution tools individually or in combination, in case certain trigger conditions for resolution are met as follows:

- the determination that the bank is failing or is likely to fail;
- there is no reasonable prospect that any alternative private sector measures or supervisory action taken in respect of the bank would prevent the failure of the latter within a reasonable time frame; and
- a resolution action is necessary in the public interest.

The said resolution tools are the following:

- the sale of business;
- the bridge institution,the asset separation (which may be used only in conjunction with other tools); and
- the bail-in tool.

Additionally, in adverse conditions of a systemic crisis, extraordinary public financial support may be provided through (additional) financial stabilisation tools, which consist of public equity support and temporary public ownership (Articles 57 and 58 of the BRRD Law).

The application of the above measures is subject to certain conditions and requirements whereas, for the purposes of selecting the appropriate tool, the national resolution authorities should take a wide range of factors into consideration (eg, the feasibility and the credibility of the bank in resolution).

### The Bail-in Tool

In brief, use of the bail-in tool in the context of a potential recapitalisation of a bank means that financial assistance will be drawn from the national resolution fund for the restructuring of such bank's liabilities.

Pursuant to Article 44 of the BRRD Law, applying the bail-in tool to draw funds from TEKE in favour of a Greek bank requires that:

- a contribution to loss absorption amounting to at least 8% of the total liabilities of the bank (including own funds) is made by common shareholders, holders of other instruments of ownership, holders of capital instruments and holders of other eligible liabilities and takes effect through write-down, conversion or otherwise; and
- the contribution of TEKE does not exceed 5% of the total liabilities of the bank (including own funds).

Bank deposits that undergo a recapitalisation procedure are guaranteed up to EUR100,000; under exceptional circumstances, uninsured (eligible) deposits held by natural persons or small and medium-sized enterprises might be excluded in whole or in part from the application of write-down or conversion powers.

### Ranking of Claims

By virtue of the BRRD Law, as in force, a new Article 145A was introduced into the Banking Law determining the ranking of claims upon special liquidation of a bank. More specifically, in accordance with Article 145A, as amended by virtue of Laws 4340/2015, 4346/2015 and 4438/2016, the following claims are ranked preferentially in the following order:

- claims under point (v) from Article 154 of the Bankruptcy Code (namely, claims deriving from the provision of food to the debtor, his or her spouse and his or her children, if such costs arose during the last six months prior to the declaration of bankruptcy);
  - (a) Greek State claims arising in case of recapitalisation by the Greek State of banks pursuant to Articles 57 or 58 of the BRRD Law;
  - (b) claims deriving from guaranteed deposits;
  - (c) any type of Greek State claim aggregated with any surcharges and interest charged on these claims;
  - (d) the following claims:
  - (e) claims of the resolution fund, in case of provision of financing to the institution;
  - (f) claims deriving from eligible deposits to the extent that they exceed the coverage threshold for deposits of natural persons and micro, small and medium-sized enterprises;
  - (g) claims deriving from investment services that are covered by TEKE;
  - (h) claims deriving from eligible deposits to the extent that they exceed the coverage limit and do not fall under point (e) above; claims deriving from deposits exempted from compensation pursuant to Article 11 of Law 3746/2009, which, however, do not include deposits falling under points 3, 14, 15 of this provision; and
  - (i) all claims that do not fall within the above listed points and are not subordinated claims as per the relevant agreement, including liabilities under loan agreements and other credit agreements, agreements for the supply of goods or for the provision of services or from derivatives.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

#### NPLs

As a result of the debt sovereign crisis of the past 12 years (2008-20) the Greek political, economical and social environment has changed dramatically. Amendments to the insolvency law, implementation of an out-of-court process, improvements to the judicial system, and creation of a special servicing sector are some of the developments that have contributed most, lowering the ratio to 40% as of 2019. The aim of the banks, according to their business plans shared with the SSM for 2019 to 2021, was the reduction of their NPLs by EUR55 billion.

In 2019, the fundamentals and prospects of the Greek economy improved, positively affecting the financial system. However, the COVID-19 pandemic crisis disrupted global financial stability and reversed the growth prospects of the Greek economy for 2020, which until then had been benign. Concurrently, the pandemic crisis heightened short and medium-term risks for the Greek banking sector. Pursuant to the BoG's predictions, the economic repercussions of the COVID-19 pandemic are expected to take their toll on banks' asset quality once again via the creation of new NPLs. This impact cannot be accurately measured as yet due to, inter alia, the debt moratorium applicable until the end of the year. This is as per the decisions made by banks in the context of measures put in place to support households and non-financial corporations adversely impacted by the pandemic.

In the context of the NPLs reduction objective, the Hercules Asset Protection Scheme (HAPS), a plan similar to Italy's *Garanzia sulla Cartolarizzazione delle Sofferenze* model, was legislated in December 2019 by the Greek Parliament (Law 4649/2019). The HAPS provides the Greek government a guarantee against consideration for the benefit of holders of the most senior class of asset-backed securities issued by securitisation special purpose vehicles, in the context of transactions involving the disposal of NPLs originated by Greek banks. The HAPS aims to facilitate raising resources in the context of securitisation transactions and make this funding option more attractive for third-party investors. It is a scheme that is expected to clean up around EUR30 billion of bad loans from the banks' balance sheets. Greek banks are already in the process of making use of the HAPS by offloading part of their delinquent loans. One systemic bank has already completed a securitisation transaction.

Nonetheless, based on BoG staff estimates, the NPL ratio is estimated to reach approximately 25%, remaining the highest in the EU and a multiple of EU and SSM averages.

### EU Banking "Quick Fix" Regulation

On 26 June 2020, Regulation (EU) 2020/873 was published in the Official Journal of the EU (OJ), amending the CRR and the revised Capital Requirements Regulation (CRR II) (the CRR "quick fix" Regulation). The CRR "quick fix" Regulation, forming part of the EU's response to the COVID-19 pandemic, applies as of 27 June 2020, with the exception of the amendments to the calculation of the leverage ratio, which will apply from 28 June 2021. Briefly, the CRR "quick fix" Regulation:

- extends, by two years, the transitional measures for the implementation of IFRS 9;
- amends the CRR II discretion to disallow the exclusion of central bank debt from a leverage ratio, which would be effective from June 28 2021, to be a one-off assessment at the point of drawdown;
- delays the implementation of the leverage ratio buffer requirement for G-SIBs, provided for in CRR II, from January 1 2022 to January 1 2023;
- ensures that non-performing loans guaranteed or counter-guaranteed by the public sector receive the beneficial risk-weighting extended to export credit;
- brings forward the implementation date of the software asset deduction exemption, which is an exemption from the requirement to deduct certain software assets from CET 1 capital, making it available from the date the related technical standards enter into force; and
- changes the application date from June 2021 to June 2020 of the measure lowering the capital cost for retail loans, introduced by CRR II for loans granted by banks to pensioners or employees with a permanent contract against the unconditional transfer of part of the borrower's pension or salary, changes to the SME supporting factor and the new infrastructure supporting factor.

### New AML/CTF Framework

By the end of 2020, the following regulatory developments on AML/CTF are expected.

- The implementation of the new AML/CTF Legislation (Directive (EU) 2018/1673, the AMLD VI) — expected to be implemented by 3 December 2020 and applicable from 3 June 2021. Implementation of AMLD VI shall harmonise the definition of AML/CTF across the EU with the goal of removing loopholes in the domestic legislation of member states. In more detail, as a response to changing criminal methodologies and legislative priorities, AMLD VI provides a harmonised list of the 22 predicate offenses that constitute AML/CTF, including certain tax crimes, environmental crime and cybercrime. The inclusion of cybercrime as a predicate offense is significant since it is the first time it has been featured in this context in an EU money laundering directive; and
- The replacement of the BoG AML/CTF Decision.

### Compliance with COVID-19 Measures

The current sanitary crisis has forced banks to comply with a number of anti-COVID-19 measures and amend their policies and procedures accordingly while taking digitalisation initiatives. Such measures include:

- establishment of procedures for social distancing and remote working (smart working); and
- implementation of thermal cameras and the testing of body temperature procedures.

The implementation of the aforesaid measures has a significant impact on banks' data protection policies which must be amended accordingly to reflect new requirements while maintaining the enhanced confidentiality and data protection obligations required pursuant to the provisions of the General Data Protection Regulation (EU/679/2016) and Law 4624/2019 in implementation thereof.

### COVID-19 Suspension and Support Measures

The Greek Banks Association announced suspension measures with respect to performing loans granted to businesses directly affected by COVID-19. In particular, payment of relevant instalments is suspended until the end of 2020. During this period, debtors shall only pay interest on their loans and no payments of principal will be made.

Moreover, a state aid scheme has been introduced in the form of guarantees granted by the Hellenic Development Bank (HDB), for eligible working capital loans. The guarantee covers 80% of the eligible costs — outstanding balance, interest and levy of Law 128/1975 — for term loans (including bond loans) meeting certain eligibility criteria. The newly established COVID-19 Guarantee Fund of the HDB will be responsible for the implementation of the scheme, which will be co-financed by the EU structural funds (ESIF).The HDB also introduced an interest subsidy scheme for businesses affected by COVID-19, for working capital loans granted by banks.

Banks are also obliged to facilitate debtors directly affected by the measures imposed by the government due to the sanitary circumstances. Such measures include:

- communication with debtors in order to record the affected households and businesses;
- provision of settlement proposals and customised solutions, including reduction or suspension of instalments payable for a three-month period;
- immediate suspension of payment of instalments for a three-month period for debtors who are eligible for the EUR800 special purpose compensation;
- suspension of any communications relating to any payments in arrears with debtors who claim a proven severe and factual inability to perform their payment obligations; and
- instruction of external partners, such as debt notification companies and legal offices, to fully synchronise the content and frequency of their direct communications with debtors regarding the above actions.

**Moratis Passas Law Firm** has since its inception acted as adviser to many key firms in the Greek banking and financial market. The firm's breadth of experience has been widely recognised and has secured it top-tier ranking among Greek law firms, especially in the banking and finance sectors. Moratis Passas is widely recognised for its leading banking, capital markets, finance and regulatory expertise. This and its multi-jurisdictional capacity enable the firm to provide an international perspective coupled with an understanding of local clients' needs. Moratis Passas often acts for clients from around the world on high-profile and complex financial transactions and projects. It has extensive experience and a proven track record in mergers and acquisitions, securitisation projects, joint ventures, shareholders' agreements, company and partnership formations as well as in general corporate governance, representation and day-to-day business matters.

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MORATIS PASSAS
LAW FIRM

# HONG KONG

## Law and Practice


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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Regulators

The Hong Kong Monetary Authority (HKMA) is the central banking institution of Hong Kong, as well as the principal regulator responsible for maintaining the stability of the currency and banking system in Hong Kong.

The HKMA's functions include:

- supervising compliance with the Banking Ordinance (Cap. 155, Laws of Hong Kong) (BO);
- ensuring that banks are operated in a responsible, honest and business-like manner;
- promoting and encouraging proper standards of conduct and sound and prudent business practices amongst banks; and
- ensuring that banking business is carried on with integrity, prudence and the appropriate degree of professional competence, and in a manner that is not detrimental to the interests of depositors.

If a bank also carries on business in one or more regulated activities under the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) (SFO), it must register with the Securities and Futures Commission (SFC) as a "registered institution". Regulated activities include (but are not limited to) dealing in securities, advising on securities, advising on corporate finance, and asset management.

The HKMA and the SFC have entered into a Memorandum of Understanding which sets out (amongst other things) the roles and responsibilities of the HKMA and the SFC when supervising registered institutions, including how information will be exchanged between the regulators.

Banks may also engage in a number of ancillary businesses (including through their subsidiaries), such as providing mandatory provident fund services, trust business and/or insurance. Depending on the businesses conducted, other licences and registrations may be applicable, alongside supervision by other regulators. This guide will only discuss the principal laws and regulations governing the banking sector.

### Principal Laws and Regulations Governing the Banking Sector

The BO (and its subsidiary legislation) is the principal legislation establishing the legal framework for banks in Hong Kong. The HKMA also publishes various supplementary guidance to banks, including through:

- its Supervisory Policy Manual (SPM);
- guidelines;
- circulars;
- codes of practice;
- explanatory notes; and
- practice notes.

Other legislation in Hong Kong will also be applicable to banks, including (but not limited to):

- the Companies Ordinance (Cap. 622, Laws of Hong Kong);
- the Deposit Protection Scheme Ordinance (Cap. 581, Laws of Hong Kong) (DPSO);
- the Personal Data (Privacy) Ordinance (Cap. 486, Laws of Hong Kong) (PDPO);
- the Financial Institutions (Resolution) Ordinance (Cap. 628, Laws of Hong Kong) (FIRO);
- the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap.615, Laws of Hong Kong) (AMLO);
- the Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405, Laws of Hong Kong) (DTRPO);
- the Organised and Serious Crimes Ordinance (Cap. 455, Laws of Hong Kong) (OSCO);
- the United Nations Sanctions Ordinance (Cap. 537, Laws of Hong Kong);
- the United Nations (Anti-Terrorism Measures) Ordinance (Cap. 575, Laws of Hong Kong) (UNATMO); and
- the Prevention of Bribery Ordinance (Cap. 201, Laws of Hong Kong).

Fully licensed banks are required to be a member of The Hong Kong Association of Banks (HKAB), which is a statutory body consisting of all of the fully licensed banks in Hong Kong. Restricted licence banks and deposit-taking companies have also established their own equivalent body: the Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies (DTC Association). The HKAB and the DTC Association publish codes, guidelines and rules, which member banks are expected to comply with.

Banks that are also "registered institutions" are required to comply with the requirements under the SFO (and its subsidiary legislation) when carrying on the regulated activities. The SFC also publishes various guidance in the form of codes, guidelines, circulars and frequently asked questions, which registered institutions will need to comply with.

## 2. Authorisation

### 2.1 Licences and Application Process

#### Types of Licences, Activities and Services Covered, and Restrictions on Licensed Banks' Activities

Under the BO, Hong Kong has a three-tier banking system, comprising licensed banks, restricted licence banks, and deposit-taking companies (collectively known as authorised institutions, or AIs).

They are classified according to the nature of their business, and the amount and term of the deposits accepted, as follows:

- Licensed banks:
  - (a) may carry on banking business (such as receiving deposits from the general public, and paying or collecting cheques drawn by or paid in by customers); and
  - (b) may take deposits of any size and maturity from the public.
- Restricted licence banks:
  - (a) are principally engaged in merchant banking and capital market activities; and
  - (b) may take deposits of HKD500,000 and above without restriction on maturity.
- Deposit-taking companies:
  - (a) are mostly owned by or otherwise associated with banks;
  - (b) may engage in a range of specialised activities, including consumer finance, commercial lending and securities business; and
  - (c) may take deposits of HKD100,000 or above with an original term of maturity of at least three months.

To facilitate the establishment of "virtual banks" in Hong Kong, in 2018 the HKMA published a revised "Guideline on Authorisation of Virtual Banks", setting out principles which the HKMA will take into account during the authorisation process for virtual banks. A virtual bank is a bank that primarily delivers retail banking services through the internet or other forms of electronic channels instead of via physical branches.

Alternatively, an overseas bank may establish a local representative office in Hong Kong, whose role is confined mainly to liaison work with customers in Hong Kong; it is not allowed to engage in any banking business.

#### Statutory and Other Conditions for Authorisation

Under the BO, the HKMA has general discretion to grant or refuse an application for authorisation to operate a banking business or a business of taking deposits in Hong Kong. The HKMA is, however, obliged to refuse to authorise an applicant if the minimum criteria for authorisation are not fulfilled. These minimum criteria are set out in the Seventh Schedule to the BO and apply at the time of authorisation, and on a continuing basis thereafter. The manner in which the HKMA interprets them is set out in the "Guide to Authorisation" issued by the HKMA.

The minimum criteria for authorisation include, but are not limited to, the following:

- the applicant bank fulfilling the minimum capital requirement;
- the applicant bank being adequately supervised in its home country if it is an overseas bank;
- the chief executive, directors, controllers and executive officers of the applicant bank being fit and proper persons;
- the applicant bank's financial positions in terms of capital, liquidity and asset quality being sound;
- the applicant bank's internal controls and accounting systems being adequate; and
- the business of the applicant bank being carried out with integrity, prudence and competence.

When granting authorisation, the HKMA may impose conditions on the applicant bank or its controllers/holding companies.

#### Process for Applying for Authorisation

Prior to submitting a formal application, the HKMA encourages the applicant bank to discuss its plans with the HKMA. During the preliminary consultation, the HKMA and the applicant bank will discuss the proposed business plan and intended activities of the bank.

For the formal application, the applicant bank is required to submit an application letter to the HKMA stating the reasons for the application for authorisation, the background of the applicant, and how the relevant authorisation criteria are, or will be, met by the applicant. The applicant will also be required to submit a number of documents set out in Annex 2 of the HKMA's "Guide to Authorisation".

After receiving the application, the HKMA will review the documents to ensure that the minimum criteria for authorisation are satisfied and raise any queries they have with the applicant bank.

The time required to process an application will depend on a number of factors (such as the speed at which the application documents are prepared and the ability of the applicant to respond to the HKMA's queries) but can take approximately nine to 12 months from preparation for the preliminary consultation with the HKMA to the receipt of approval-in-principle from the HKMA.

Upon authorisation, a bank is currently required to pay a fee of HKD474,340 (for fully licensed banks), HKD384,270 (for restricted licence banks) or HKD113,020 (for deposit-taking companies).

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

#### Requirements Governing Changes in Control

The BO provides that no person shall become a "controller" of a Hong Kong-incorporated bank without the prior approval of the HKMA. A "controller" is defined as:

- any person in accordance with whose directions or instructions the directors of the company or of another company of which it is a subsidiary are accustomed to act (an "indirect controller");
- any person who, either alone or with any associate or associates, is entitled to exercise, or control the exercise of, more than 50% of the voting power at any general meeting of the company or of another company of which it is a subsidiary (a "majority shareholder controller"); and
- any person who, either alone or with any associate or associates, is entitled to exercise, or control the exercise of, 10% or more, but not more than 50%, of the voting power at any general meeting of the company or of another company of which it is a subsidiary (a "minority shareholder controller").

The HKMA must be satisfied that the "controller" is a fit and proper person to become a controller of the bank.

Generally, there are no statutory restrictions on foreign entities acquiring or increasing control over a Hong Kong-incorporated bank. However, conditions have been placed on the note-issuing banks in Hong Kong (ie, commercial banks in Hong Kong that are authorised to issue currency notes) such that they shall have no close association with any foreign government or foreign government-controlled entity that – either alone or with associates – is entitled to exercise or control the exercise of 20% or more of the voting power at any general meeting of the bank or its holding company, or either directly or indirectly influences or seeks to influence any aspect of the management or business of the bank.

If a majority shareholder controller is incorporated outside Hong Kong, the HKMA may also require the controller to establish a holding company incorporated in Hong Kong, whose sole purpose will be to hold the shares of the bank; this "intermediate" holding company may itself be subject to certain conditions, in addition to those imposed on the bank and its ultimate holding company (if applicable).

For banks incorporated outside Hong Kong, no statutory approval will be needed from the HKMA upon a change in control, although the HKMA still must be satisfied that the controller is fit and proper; the HKMA will rely heavily on the views of the home supervisor in making this assessment.

#### Nature of the Regulatory Filings and Related Obligations

To become a controller of a Hong Kong-incorporated bank, a person must apply to the HKMA prior to the change in control by serving a notice in writing to the HKMA and submitting supporting documents required by the HKMA. The relevant documents will depend on the percentage shareholding acquired and the nature of the proposed controller.

A person may then become a controller if the HKMA serves a "notice of consent" before the expiration of three months from the date of service of the notice, or if that period expires without the HKMA having served a "notice of objection"; if the HKMA requests information from the person, the time period before expiry will be extended.

The HKMA may choose to place conditions on the controller when granting its approval.

## 4. Supervision

### 4.1 Corporate Governance Requirements

#### Corporate Governance Framework

As one of the minimum criteria for authorisation, the HKMA must be satisfied that the bank has adequate systems of control. Banks are required to maintain high standards of corporate governance to ensure that there is adequate board and senior management oversight of the risk management and control systems. The HKMA places great importance on effective corporate governance within banks to ensure that the banking business is managed in a controlled and prudent manner.

The main corporate governance and systems and controls requirements applicable to banks are set out in SPM CG-1 "Corporate Governance of Locally Incorporated Authorised Institutions" issued by the HKMA. SPM CG-1 is applicable to all Hong Kong-incorporated banks, although banks incorporated outside Hong Kong should have reference to the applicable principles. Some key components of the corporate governance frameworks are also contained in other relevant SPM modules, and the HKMA also sets out its expectations in various additional guidance and circulars from time to time.

### Board and Senior Management

SPM CG-1 provides that the bank's board of directors is ultimately responsible for ensuring that the bank complies with all laws and regulations in Hong Kong.

It is generally expected that a Hong Kong-incorporated bank will establish various board committees (such as a nomination committee, audit committee, risk committee, remuneration committee and culture committee) composed of directors (including independent non-executive directors (INEDs)) as part of the bank's corporate governance framework.

The HKMA also expects that either one-third or three of the board members (whichever is higher) of a fully licensed bank will be INEDs, and at least two of these INEDs should have a background in accounting, banking or another relevant financial industry.

Senior management who are responsible and accountable for running a bank on a day-to-day basis should ensure that the bank's activities are consistent with the business strategy, risk appetite and policies approved by the board.

### Bank Culture Reform

In recent years, the HKMA has stressed the need for banks to develop and promote a sound corporate culture that supports prudent risk management and high ethical standards. In particular, the HKMA has stressed that the board and senior management of banks must (i) establish the banks' culture and behavioural standards that promote prudent risk-taking and fair treatment of customers, (ii) design appropriate incentive systems to promote cultural and behavioural standards, and (iii) develop appropriate tools to monitor the adherence of individual business units and relevant staff to the banks' culture and behavioural standards.

## 4.2 Registration and Oversight of Senior Management

As one of the minimum criteria for authorisation, the HKMA must be satisfied that every director, manager, chief executive and executive officer of the bank is a fit and proper person.

Under the BO, consent from the HKMA is required for the appointment of directors (for Hong Kong-incorporated banks) and chief executives. In considering whether the directors or chief executives are fit and proper persons, the HKMA will have regard to the following factors:

- their reputation and character;
- their knowledge and experience, competence, soundness of judgement and diligence;
- whether they have a record of non-compliance with non-statutory codes or disciplinary records; and
- their business records and other business interests.

Banks that are also "registered institutions" are required to appoint at least two individuals as "executive officers" to be responsible for directly supervising the conduct of each regulated activity. Under the BO, consent from the HKMA is required for the appointment of executive officers. In assessing the fitness and proprietary of executive officers, the HKMA will have regard towards the fit and proper guidelines set out in the SFO and various guidance published by the SFC.

The HKMA may conduct face-to-face meetings to assess a candidate's personal qualities, skills, knowledge and understanding of the bank's business, key regulatory and supervisory requirements, and whether the candidate will be able to adequately fulfil the proposed role.

Banks are also required to notify the HKMA when they appoint "managers" (persons who are responsible for the conduct of certain prescribed functions in the bank, such as information technology, internal audit and compliance). The HKMA must continue to be satisfied that managers appointed by the banks are fit and proper persons.

### Roles and Responsibilities

The board has the ultimate responsibility for the operations and financial soundness of the bank. Key roles and responsibilities of the board include:

- setting and overseeing the objectives of the bank and the strategies for achieving the objectives;
- establishing and overseeing risk governance;
- appointing and overseeing senior management; and
- setting corporate values and standards.

Senior management appointed by the board to operate the bank on a day-to-day basis have key roles and responsibilities, including:

- implementing business and risk strategies approved by the board;
- providing the board with regular, adequate and comprehensible information in relation to material matters of the bank;
- ensuring the risk limits are consistent with the bank's overall risk appetite;
- establishing an effective information management system to report to the board and senior management;
- establishing a management structure that promotes accountability and transparency throughout the organisation, and

facilitates the delegation of duties to staff, and oversight of those they manage; and
- ensuring the competence of the managers and staff responsible for the business and internal control functions of the bank.

### 4.3 Remuneration Requirements

#### Remuneration Framework

The remuneration requirements are set out in SPM CG-5 "Guideline on a Sound Remuneration System", as supplemented by the HKMA in various guidance and circulars from time to time. As noted above, in recent years the HKMA has actively encouraged sound remuneration and incentive policies as part of the Bank Culture Reform.

A bank is required to establish a sound remuneration policy that is appropriate and consistent with the bank's culture, long-term business and risk appetite. In particular, the remuneration systems established by the bank should discourage inappropriate and excessive risk-taking that could threaten the safety and soundness of the bank.

The board is ultimately responsible for overseeing the establishment and implementation of the remuneration policy. The board should establish a "remuneration committee", which is responsible for designing and operating the bank's remuneration system and making recommendations in respect of remuneration policy and practices to the board.

#### Applicability

The remuneration policy should cover all employees, particularly those who could have a material impact on the bank's risk profile and financial soundness. Specific regard should be had to the following types of employees:

- senior management personnel who are responsible for oversight of the bank's firm-wide strategy or activities or those of the bank's material business lines;
- individual employees whose duties or activities in the course of their employment involve the assumption of material risk or the taking on of material exposures on behalf of the bank;
- employees whose activities may expose the bank to material amounts of risk and who are subject to incentive arrangements; and
- employees within risk control functions.

#### Remuneration Principles

The incentive systems of the bank should reward good business performance and adherence to the bank's culture and behavioural standards commensurate with an employee's respective seniority and responsibilities. The bank's remuneration policy should avoid incentivising short-term business performance at the expense of the interests of customers and the safety and soundness of the bank.

Key remuneration principles that underpin sound remuneration polices include:

- a proportionate balance of fixed and variable remuneration;
- the use of instruments for variable remuneration;
- exceptional use of guaranteed minimum bonuses;
- pre-determined criteria for performance measurement;
- the exercise of judgement;
- the deferment of variable remuneration; and
- restrictions on hedging exposures.

#### Remuneration Disclosures

Banks are required to annually disclose matters relating to their remuneration structure and framework, such as:

- information relating to the governance structure of the remuneration system;
- information relating to the design and structure of the remuneration processes; and
- quantitative information on the amount and type of remuneration paid to senior management and key personnel.

#### Consequences of Breach

A breach of SPM CG-5 and the related guidance on remuneration may call into question whether the bank concerned continues to satisfy the minimum criteria for authorisation.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

The AMLO sets out the statutory requirements for anti-money laundering and counter-terrorist financing (AML/CTF). The HKMA also publishes various guidelines and circulars setting out its supervisory approach, in particular the "Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (for Authorised Institutions) (the AML Guideline)", which sets out the statutory and regulatory AML/CFT standards which banks should meet. Compliance with the AML Guideline is enforced through the AMLO and the BO.

Central to the effective implementation of an AML/CTF regime is the risk-based approach that banks are required to adopt when conducting business with customers.

#### Key AML/CTF Requirements

***Institutional ML/TF risk assessment***

Under the AMLO, banks are required to conduct institutional money laundering and terrorist financing (ML/TF) risk assessments to identify, assess and understand its ML/TF risks in relation to:

- its customers;
- the countries or jurisdictions its customers are from or in;
- the countries or jurisdictions the bank has operations in; and
- the products, services, transactions and delivery channels of the bank.

*AML/CTF systems*
Banks must have AML/CTF systems that are appropriate to the nature, size and complexity of the business, and that are approved and overseen by senior management.

In addition, compliance management arrangements are required to implement the AML/CTF systems, which includes the appointment of a compliance officer and a money laundering reporting officer.

*Customer due diligence*
Customer due diligence must be carried out by banks before establishing a business relationships with customers.

While simplified due diligence is permitted in low risk situations (eg, transactions with public bodies or listed companies in Hong Kong), enhanced due diligence must be carried out in high risk situations (eg, transactions with politically exposed persons and their close associates or in jurisdictions that are subjected to United Nations sanctions).

*Monitor business relationships*
Banks are required to continuously monitor business relationships with customers through:

- conducting regular reviews of customers' information to ensure that they are up-to-date and relevant; and
- conducting appropriate monitoring of transactions carried out for the customers and identifying transactions that are unusually large in amount or have no apparent economic/lawful purpose.

*Record-keeping*
Records must be maintained by banks relating to customer due diligence and transactions throughout the duration of the business relationships with their customers and for at least five years after the end of the business relationships.

*Staff training*
Banks are required to implement policies to ensure that their staff are adequately trained to implement the AML/CTF systems. The scope and frequency of AML/CTF training should be tailored to the specific risks faced by the bank.

*Suspicious transaction reporting*
Under the DTRPO, OSCO and UNATMO, banks are under a statutory obligation to report suspicious transactions to the Joint Financial Intelligence Unit (which is jointly run by the Hong Kong Police Force and the Hong Kong Customs and Excise Department); failure to report knowledge or suspicion is a criminal offence.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

### Deposit Protection Scheme
The DPSO establishes the deposit protection scheme (the Scheme), which is operated by the Hong Kong Deposit Protection Board (DPB).

All licensed banks are required to be members of the Scheme, which protects depositors (both individuals and corporations) in Hong Kong by paying compensation in the event of the failure of a bank. A depositor is entitled to be compensated up to a maximum of HKD500,000 per bank.

Depositors are not required to apply to the banks nor pay any fee for protection under the Scheme. The Scheme is funded by annual contributions paid by Scheme members, with the amount being determined by the size of protected deposits held with the Scheme members and the supervisory ratings assigned to them by the HKMA.

Deposits held with restricted licence banks and deposit-taking companies are not protected by the Scheme.

### Types of Deposits Protected under the Scheme
Most of the commonly placed bank deposits (in any currency) qualify for protection under the Scheme, including current accounts, savings accounts, secured deposits and time deposits with a maturity not exceeding five years.

### Type of Deposits That Are Not Protected under the Scheme
Deposits that are not protected under the Scheme are set out in the First Schedule to the DPSO and include the following, amongst others:

- structured deposits;
- time deposits longer than five years in maturity;
- bearer instruments (eg, bearer certificates of deposit);
- offshore deposits;

- deposits held for the account of the Exchange Fund of Hong Kong; and
- deposits held by an excluded person (eg, a related company of a Scheme member, multilateral development banks, licensed banks, restricted licence banks, deposit-taking companies, foreign banks, senior management, and controllers and directors of a Scheme member and its related companies).

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

#### Duty of Secrecy

Under Hong Kong law, banks are under a common law duty to maintain secrecy in relation to the customer's account, their transactions and any other information concerning the customer's affairs. This duty is an implied term of the contract between a banker and its customer.

A "customer" is someone (individual or corporate) who has an account with a bank (where the relationship is that of debtor-creditor), or who interacts with the bank such that the relationship of banker and customer exists, even though at that stage there is no account being opened.

The duty of secrecy arises when the relationship of banker and customer is established, and continues even after the account is closed or the relationship ends.

#### Principal Exceptions Permitting Disclosure

The duty of secrecy is not absolute and is subject to four major exceptions:

- where disclosure is under compulsion of law (eg, disclosure in relation to suspicion of money laundering or terrorist financing);
- where there is a duty to the public to disclose;
- where the interests of the bank require disclosure (eg, defending itself against potential liability to third parties); and
- where the disclosure is made with the consent of the customer – consent can be express or implied, and may be given generally or limited to specific information.

#### Consequences of Breach of the Duty

A customer may have a claim for damages and/or seek injunctive relief if the bank breaches its duty of secrecy.

#### Other Confidentiality Obligations

Apart from the common law duty of secrecy, confidentiality obligations may also arise in the following scenarios:

- as a result of express contractual obligations;
- where a bank is placed in a fiduciary position;
- from the equitable law of confidence, which may confer an obligation to maintain the confidentiality of disclosures made to a person in a professional capacity (such as a banker);
- from the HKMA's guidance; and
- by virtue of legislation, such as the PDPO and related guidance from the Office of the Privacy Commissioner for Personal Data (the Commissioner), the dedicated data privacy regulator.

##### *HKMA guidance*

The HKMA's guidance includes circulars on customer data protection and the HKMA's SPM SA-2 "Outsourcing", which requires banks to ensure that any outsourcing arrangement complies with relevant statutory and common law customer confidentiality requirements, and regulatory expectations.

The HKMA has also endorsed – and expects banks to comply with – the HKAB's "Code of Banking Practice" (the Code), which is a non-statutory, voluntary code that applies to personal customers (ie, private individuals). The Code requires banks to treat existing and former customers' banking affairs as private and confidential, and to comply with the PDPO and related guidance from the Commissioner.

Breach of the HKMA's regulatory guidance or the Code may lead to the HKMA disciplining the bank.

##### *PDPO*

The PDPO regulates personal data protection in Hong Kong and, among other things, outlines how data users (such as banks) should collect, handle and use personal data. Personal data means any data relating directly or indirectly to a living individual and from which it is practicable for the identity of the individual to be directly or indirectly ascertained, if such data is in a form in which access to or processing of it is practicable.

Exemptions from compliance are available – eg, where personal data is required under any law or court order, for legal proceedings, or for the exercising or defending of legal rights.

The Commissioner has issued codes of practice and published guidance on handling personal data, including the "Guidance on the Proper Handling of Customers' Personal Data for the Banking Industry", the "Code of Practice on Consumer Credit Data", and the "New Guidance on Direct Marketing".

Breaches of the PDPO may lead to civil actions and/or constitute criminal offences, which may result in fines and imprisonment.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Framework

Under the BO and its subsidiary legislation, banks are required to maintain adequate capital adequacy and liquidity ratios. The HKMA has implemented the Basel III requirements in accordance with the timeline set out by Basel Committee on Banking Supervision (the Basel Committee).

Following the announcement of the deferral of implementation of the Basel III final reform package by the Basel Committee, the HKMA announced the deferral of the Basel III final reform package in Hong Kong by one year – to 1 January 2023.

### Capital Requirements

Banks incorporated in Hong Kong are required to follow the capital requirements set out in the Banking (Capital) Rules (Cap. 155, Laws of Hong Kong), which implement the Basel III standards on minimum capital requirements.

The HKMA's SPM CA-G-1 "Overview of Capital Adequacy Regime for Locally Incorporated Authorised Institutions" provides guidance on the calculation of the capital adequacy ratio (CAR), which is the collective term that refers to the three risk-weighted capital ratios:

- Common Equity Tier 1 (CET1) capital ratio;
- Tier 1 capital ratio; and
- total capital ratio.

Banks incorporated in Hong Kong are required to maintain a CET1 capital ratio of at least 4.5%, a Tier 1 capital ratio of at least 6% and a total capital ratio of at least 8%.

The CAR requirements for Hong Kong-incorporated banks are calculated on a solo basis or on a consolidated basis, both of which measure the capital adequacy of a bank based on the capital strength, risk profile, or the on- and off-balance sheet exposures of the bank. The solo basis takes into account the combined position of the bank's head office and branches (both in Hong Kong and overseas), whereas the consolidated basis includes assets and liabilities of the bank's subsidiaries as specified by the HKMA. However, generally, only subsidiaries undertaking relevant financial activities (eg, lending, financial leasing, custodial/safekeeping, etc) would be specified by the HKMA for the consolidated basis. A bank may also apply to include a subsidiary in the calculation of its solo CAR (a "solo-consolidated" basis) if the subsidiary satisfies certain criteria set out by the HKMA.

Foreign banks operating via a branch in Hong Kong are not subject to these requirements. However, the HKMA would generally require a foreign bank that wishes to set up a branch or subsidiary in Hong Kong to maintain capital levels consistent with the latest applicable capital standards issued by the Basel Committee.

### Capital Buffers

To bolster the resilience of the banking sector against adverse economic developments, Hong Kong-incorporated banks are also required to maintain capital buffers, including the following:

- a capital conservation buffer, which is a band of CET1 capital equal to CET1 capital equal to 2.5% of risk-weighted assets;
- a countercyclical capital buffer (CCyB), which operates as an extension of the capital conservation buffer and is meant to build up additional capital during periods where excessive credit growth leads to a build-up of system-wide risks in the Hong Kong financial system. The CCyB is expected to be "released" when the credit cycle turns to absorb losses and enable the banking system to continue lending in the subsequent downturn; and
- a higher loss absorbency (HLA) buffer for global systemically important banks (G-SIBs) (there are currently none headquartered and incorporated in Hong Kong) or domestic systemically important banks (D-SIBs). The HLA requirement applicable to a D-SIB (expressed as a ratio of a bank's CET1 capital to its risk-weighted assets as calculated under the Banking (Capital) Rules) ranges between 1% and 3.5% (depending on the level of the D-SIB's systemic importance). The HLA requirement (together with the countercyclical capital buffer) is an extension of the Basel III capital conservation buffer.

Where a bank's net CET1 capital ratio equals or falls below the required buffer level (being its capital conservation buffer as extended by any CCyB and HLA requirement (if applicable)), restrictions will be imposed on the bank's discretionary distributions (eg, dividends, share buybacks, discretionary bonus payments to staff, etc).

The HKMA will generally require banks to comply with the minimum CAR requirements on a consolidated basis, in addition to a solo/solo-consolidated basis.

### Liquidity Requirements

The liquidity requirements are set out in the Banking (Liquidity) Rules (Cap. 155Q, Laws of Hong Kong), which implement Basel III liquidity standards. The HKMA's SPM LM-1 "Regulatory Framework for Supervisory of Liquidity Risk" provides guidance on the statutory liquidity requirements.

***Liquidity coverage ratio***

The liquidity coverage ratio (LCR) is only applicable to category 1 institutions, which include internationally active or sophisticated banks that are significant to the general stability of the banking system in Hong Kong.

Expressed as a percentage, the LCR is the total weighted amount of a category 1 institution's "high-quality liquid assets" over the total weighted amount of its "total net cash outflows" over 30 calendar days.

All category 1 institutions must maintain an LCR of at least 100% at all times.

***Liquidity maintenance ratio***

Banks that are not designated as category 1 institutions (ie, category 2 institutions) are subject to a liquidity maintenance ratio (LMR), which is a local liquidity standard developed by the HKMA. Expressed as a percentage, the LMR is the amount of a category 2 institution's "liquefiable assets" over the amount of the institution's "qualifying liabilities" (after deductions) over a calendar month.

All category 2 institutions must maintain an LMR of at least 25% on average in each calendar month.

***Net stable funding ratio***

To reduce funding risk over a longer time horizon, banks are required to fund their activities with sufficient stable sources of funding.

All category 1 institutions must maintain, at all times, a net stable funding ratio (NSFR) of 100%, unless self-rectification provisions apply. Expressed as a percentage, the NSFR is the amount of a category 1 institution's "available stable funding" over the amount of the institution's "required stable funding".

Category 2 institutions designated by the HKMA as category 2A institutions must maintain, on average, a core funding ratio (CFR) of at least 75% in each calendar month. Expressed as a percentage, the CFR is the amount of a category 2A institution's "available core funding" over the amount of the institution's "required core funding".

The LCR, LMR, NSFR and CFR (as applicable) apply to banks, irrespective of their place of incorporation, and must be calculated on the basis of the bank's business in Hong Kong ("Hong Kong office basis").

A bank incorporated in Hong Kong with overseas branches must calculate the LCR, LMR, NSFR and CFR (as applicable) on an unconsolidated basis, covering all of its business in Hong Kong and overseas branches.

The HKMA may also require a Hong Kong-incorporated bank with any "associated entity" (eg, the bank's subsidiary, an entity of which the bank is able to control 20% or more of the voting power, or an entity where the bank has significant influence over its conduct) to make calculations on a consolidated basis, being the bank's Hong Kong office basis or an unconsolidated basis (where applicable) plus one or more of its associated entities specified by the HKMA.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

**Recovery Framework**

The HKMA may require banks (either those incorporated in Hong Kong or the Hong Kong branch of overseas-incorporated banks) to prepare and maintain a plan setting out the measures that the banks can take to stabilise and restore their financial resources and viability when they come under severe stress.

The HKMA's SPM RE-1 "Recovery Planning" provides guidance for banks in establishing their recovery plans. SPM RE-1 is applicable to Hong Kong-incorporated banks and Hong Kong branches of banks incorporated outside Hong Kong. However, the HKMA recognises that a proportionate approach is required to recovery planning; SPM RE-1 applies in a proportionate manner, having regard to the bank's size, structure and business mix, and to the systemic risks associated with the bank's activities. SPM RE-1 largely complies with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (the Key Attributes).

***Recovery plan***

A bank's recovery plan should:

- form an integral part of the bank's risk management framework;
- identify and explain how the bank will monitor the need to trigger recovery actions;
- set out a full menu of credible recovery options to cope with a range of stress scenarios;
- assess the impact, timeframe for implementation and probable success of the recovery options and the associated risks;
- define the criteria for triggering the implementation of the recovery plan or individual recovery options in it;

- identify the key steps, milestones and processes for implementing the recovery options and the key management personnel involved in activation and decision-making;
- ensure that the bank has appropriate contingency arrangements in place that would enable it to continue to operate as it implements recovery measures;
- assess the additional requirements that may be needed during crisis situations in order to maintain the bank's membership of, or continued access to, financial market infrastructure; and
- map out a communication strategy with the authorities, public, financial markets, staff and other stakeholders to support the deployment of the recovery options.

The HKMA notes that simpler recovery plans may suffice for smaller Hong Kong-incorporated banks and Hong Kong branches of banks incorporated outside Hong Kong with relatively simple business models and a limited scale of business activities in Hong Kong; however, the bank's recovery plan must still cover the elements set out above.

**Resolution Framework**

The FIRO establishes the legal basis for a cross-sectoral resolution regime in Hong Kong. Under the FIRO, the HKMA is the designated resolution authority for the banking sector.

The FIRO is designed to be compliant with the international resolution standards set out in the Key Attributes, and has the following resolution objectives:

- to promote and maintain the stability and effective working of the financial system in Hong Kong, including the continued provision of critical financial functions;
- to protect deposits or insurance policies;
- to protect client assets; and
- to contain the costs of resolution and protect public money.

The HKMA has published a FIRO Code of Practice, which provides guidance on its approach to the resolution regime.

***Resolution planning***

The HKMA has the power to conduct resolution planning well in advance of any actual failure. Resolution planning involves:

- gathering information from the bank;
- setting and operationalising a preferred resolution strategy for the bank;
- assessing the bank's resolvability; and
- addressing impediments to resolution.

Through the resolution planning process, the HKMA will work with the relevant bank to implement any necessary changes to its legal structure, business operations and/or structure of financial resources necessary for enhancing resolvability so that its preferred resolution strategy can be implemented effectively if needed.

***Stabilisation options***

The HKMA may apply one or more of the following stabilisation options in resolving a bank:

- transfer some or all of the business of a failing bank to a purchaser;
- transfer some or all of the business of a failing bank to a bridge institution;
- transfer some or all of the assets, rights and liabilities of a failing bank to an asset management vehicle;
- bail-in; and
- as a last resort, transfer a failing bank to a temporary public ownership company.

**Depositor Preference under Insolvency**

The Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32, Laws of Hong Kong) provides the general framework for the insolvency of corporations in Hong Kong (including banks). In the event of a bank's winding-up, depositors are regarded as preferential creditors and have priority over other unsecured creditors, up to HKD500,000 per depositor.

Under the DPSO, where a depositor has been paid compensation under the Scheme, the DPB will take on the claims of depositors up to the compensation amount paid to them under the Scheme and be subrogated to the rights and remedies of the depositors.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

The HKMA continues to play an active role in promoting and enhancing the efficiency, safety and development of the banking system. Key upcoming regulatory developments include the following.

**Regulatory Response to COVID-19**

In March 2020, the Basel Committee announced that the implementation of the final Basel III reform package will be deferred by one year to 1 January 2023 as a result of the impact of COVID-19 on the global banking system. Following the Basel Committee's announcement, the HKMA also announced that the implementation of the Basel III final package in Hong Kong will be deferred accordingly.

The HKMA also stated that their 2020 Supervisor-Driven Stress Test will be postponed by one year to 2021, to provide additional operational capacity for banks to respond to the challenges brought by COVID-19.

The HKMA has closely worked with the banking sector to put repayment deferments and other measures in place to support industries and individuals that have been affected by COVID-19.

### Rolling Bad Apples

In May 2020, the HKMA issued a consultation paper entitled "Implementation of Mandatory Reference Checking Scheme to Address the 'Rolling Bad Apples' Phenomenon" (the RBA Consultation Paper). The RBA Consultation Paper outlines the HKMA's proposed framework for a "Mandatory Reference Checking Scheme" to be adopted in the local banking sector (at least initially). The purpose of the Mandatory Reference Checking Scheme is to ensure that banks are aware of, and properly assess, any previous misconduct committed by individuals who they are looking to employ.

The consultation closed in August 2020; the HKMA will be reviewing the responses and looking to establish the Mandatory Reference Checking Scheme in due course.

### Private Banking; Wealth Management; Greater Bay Area

In recent years, the HKMA has been exploring various initiatives to promote the growth of the private banking and wealth management industry. One particular area which the HKMA has looked into closely is the opportunities presented by the Greater Bay Area (GBA), which is the integrated economic and business region in South China, consisting of Hong Kong, Macao and nine other cities in Mainland China.

To further facilitate cross-border capital flows, in June 2020, the HKMA, the People's Bank of China and the Monetary Authority of Macao jointly launched the cross-boundary Wealth Management Connect pilot scheme (Wealth Management Connect) in the GBA.

Under the Wealth Management Connect, it is proposed that residents in the GBA can invest in eligible investment products distributed by banks in Hong Kong, and vice versa.

It is expected that the HKMA will continue to engage with its regulatory counterparts in the region to establish cross-boundary arrangements to promote Hong Kong as a leading centre for wealth management and private banking whilst maintaining Hong Kong's robust regulatory protections for investors.

### Green and Sustainable Banking

The HKMA has committed to promote green and sustainable banking, and has been working with banks to manage environmental, social and governance (ESG) risk. The HKMA adopts a three-phased approach to promoting green and sustainable banking:

- Phase I – the HKMA will develop a common framework to assess the "greenness baseline" of individual banks and collaborate with international bodies to provide technical support to banks;
- Phase II – the HKMA will engage the banking sector and other relevant stakeholders in a consultation on the supervisory expectation or requirement on green and sustainable banking; and
- Phase III – after setting the targets, the HKMA will implement, monitor and evaluate banks' progress.

In 2020, the HKMA took significant steps to complete Phase I and begin Phase II of the three-phased approach.

In May 2020, the HKMA, the SFC and other regulators established the Green and Sustainable Finance Cross-Agency Steering Group (the Steering Group). The main aims of the Steering Group are to co-ordinate management of climate and environmental risks to the financial sector, and to help accelerate the growth of green and sustainable finance in Hong Kong. One of the first tasks of the Steering Group is to develop a local green taxonomy for use by all financial regulators in Hong Kong (taking international standards and local circumstances into account).

The HKMA also launched a self-assessment exercise for banks on green and sustainable banking in May 2020 to assess the financial risks associated with climate and environmental issues.

In June 2020, the HKMA published the "White Paper on Green and Sustainable Banking", outlining its initial thoughts on its supervisory approach to climate and sustainability issues. The thoughts are summarised in nine guiding principles – covering the issues of governance, strategy, risk management and disclosure – and are designed to help banks develop frameworks and strategies to manage ESG risk.

The HKMA is currently reviewing the results of the banks' self-assessment exercise and collecting feedback on the White Paper in order to build on the guiding principles and formulate ESG supervisory requirements.

The HKMA plans to launch a formal consultation on ESG supervisory requirements in 2021, and to conduct a pilot climate stress testing exercise to assess the climate resilience of the banking sector.

### Technology

Promoting greater adoption of technology in the banking sector has been one of the HKMA's key work priorities in recent years. In 2020, the HKMA worked with the banking sector to explore greater use of technology in banking operations in a number of different areas, including as set out below. It is anticipated that the HKMA will continue to focus on the use of technology to improve the productivity and internal controls within the banking sector.

The HKMA has recognised that COVID-19 has brought increased demand for remote on-boarding and the digital delivery of financial services, and the use of financial technology (fintech) can provide significant support to banks in managing the challenges posed by the pandemic. The HKMA intends to continue to promote the adoption of fintech across all types of financial services.

Artificial intelligence (AI) has also been adopted in key functional areas of banks, as a way of improving efficiency and strengthening risk management. The HKMA is currently exploring the use of AI alongside the banking sector to streamline compliance processes through the use of regulatory technology (regtech) and to integrate technology into the supervisory process through the use of supervisory technology (suptech).

Since the inaugural AML/CFT Regtech Forum in 2019, there has been a significant increase in regtech adoption. With a view to fostering a larger and more diverse regtech ecosystem, the HKMA has developed a two-year roadmap to promote regtech adoption in the banking sector in its White Paper entitled "Transforming Risk Management and Compliance: Harnessing the Power of Regtech". The HKMA intends to introduce a series of events and initiatives in the next two years, with the aim of transforming Hong Kong into a regtech hub.

In September 2020, the HKMA implemented the AML/CFT Surveillance Capability Enhancement Project (the AMLS Project), which aims to strengthen the use of data and suptech in HKMA's risk-based AML/CFT supervision, and to prioritise the resources of the banking sector as a key stakeholder within the broader AML/CFT ecosystem in Hong Kong.

In November 2020, the HKMA announced the launch of the upgraded Cybersecurity Fortification Initiative (CFI) 2.0. The current CFI, which aims to raise the cyber-resilience of Hong Kong's banking system, has been enhanced to streamline the cyber-resilience assessment process while maintaining effective control standards commensurate with the latest technology trends. The CFI 2.0 will come into effect on 1 January 2021 and will be implemented in a phased approach.

During the Hong Kong Fintech Week 2020, a range of initiatives were announced by various stakeholders to further foster the banking ecosystem in Hong Kong. The HKMA announced that it will explore a new data strategy and build a "Commercial Data Interchange" to facilitate more secure and efficient data flow between banks and sources of commercial data. The HKMA also noted that Project Inthanon-LionRock (the joint study conducted by the HKMA and the Bank of Thailand on the application of central bank digital currency (CBDC) to cross-border payment) has entered the second phase; the two authorities will explore business use cases in cross-border trade settlement and capital market transactions, and enhance the cross-border corridor network prototype to support CBDCs of other central banks in the Asia Pacific region.

### Reform of Interest Rate Benchmarks

Subject to any further extension to the discontinuation deadline agreed by regulators, the London Inter-bank Offered Rate (LIBOR) will be discontinued at the end of 2021. As LIBOR is used extensively in the Hong Kong banking sector, the discontinuation of LIBOR will have significant implications on the operations of banks. To enable a smooth and timely transition before the discontinuation of LIBOR at the end of 2021, the HKMA expects banks in Hong Kong to adhere to the following transition milestones:

- banks should be in a position to offer products referencing the alternative reference rates (ARRs) to LIBOR from 1 January 2021;
- from 1 January 2021, adequate fall-back provisions should be included in all newly issued LIBOR-linked contracts that will mature after 2021; and
- banks should cease to issue new LIBOR-linked products that will mature after 2021 by 30 June 2021.

The HKMA and the Hong Kong Treasury Markets Association are also jointly evaluating the need for a suitable fall-back for Hong Kong Interbank Offered Rate (HIBOR) contracts, but the HKMA has stated that there is no current intention to discontinue HIBOR.

### Bank Culture Reform

The HKMA has announced various steps in the past few years as part of its Bank Culture Reform initiative to foster a sound corporate culture within banks. Self-assessments were conducted by banks in Hong Kong, and the HKMA published the Report on Review of Self-assessments on Bank Culture (the BC Report) in May 2020. The BC Report identified common themes and a range of practices amongst banks on how they approach their culture reform. The HKMA expects banks to adopt good practices identified in the BC Report with reference to their own circumstances.

As the next step, the HKMA will conduct focused reviews to closely look at the incentive systems of front offices of retail banks in the business of distributing banking, investment and/or insurance products. The HKMA intends to work closely with the banks during the upcoming period to promote sound bank culture and share industry-wide insights and practices on culture.

**Proposed Code of Practice for Trust Business**

In July 2020, the HKMA published a consultation paper on enhancing the regulation and supervision of trust business in Hong Kong. The HKMA proposes to introduce a Code of Practice for Trust Business (the Code for Trust Business) applicable to all banks and their subsidiaries conducting trust business. The Code for Trust Business aims to enhance the protection of client assets held on trust and to promote the fair treatment of customers and a customer-centric culture in trust business. The consultation closed in October 2020. It is anticipated that the HKMA will review the comments submitted with a view to finalising and issuing the Code for Trust Business in due course.

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## Law and Practice

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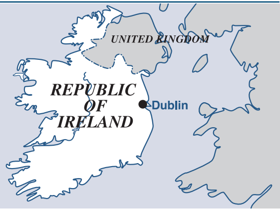


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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

Banking business in Ireland is regulated under both domestic legislation and the legislation of the EU, which is either directly applicable in Ireland or has been transposed into Irish law by domestic provisions. New laws and regulations applicable to Irish banks are primarily driven by developments at the EU level.

### Domestic Legislation

The primary domestic legislation establishing the framework for the regulation of banking activities in Ireland is the Central Bank Acts 1942-2018 (Central Bank Acts). The Central Bank Act 1942 originally established the Central Bank of Ireland (CBI) as a central bank. Following the introduction of the Central Bank Reform Act 2010 (2010 Act), the CBI is also the primary Irish financial regulatory body.

The Central Bank Act 1971 (1971 Act) establishes the requirement for persons carrying on "banking business" to hold a banking licence, and sets out certain requirements applicable to banks.

The CBI is empowered under the Central Bank Acts to issue codes of practice and regulations to be observed by banks. The CBI has issued several such codes in areas such as corporate governance, related party lending, mortgage arrears and consumer protection.

### European Legislation

Irish banks are also subject to extensive regulatory requirements driven by EU initiatives regulating the activities of "credit institutions" (the terms "credit institution" and "bank" are used interchangeably). These include the Fourth Capital Requirements Directive (2013/36/EU) (CRD IV), the Capital Requirements Regulation ((EU) 575/2013) (CRR) and the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD). CRD IV is transposed into Irish law by the European Union (Capital Requirements) Regulations 2014 (CRD IV Regulations), while the CRR, as an EU regulation, is directly applicable. BRRD is implemented in Ireland by the European Union (Bank Recovery and Resolution) Regulations 2015 (BRRD Regulations).

CRD IV has recently been amended by Directive (EU) 2019/878 (CRD V), and amendments to the CRR will be introduced by Regulation (EU) 2019/876 (CRR II) (see **10. Horizon Scanning**).

Regulation (EU) 1024/2013 (SSM Regulation) establishes the Single Supervisory Mechanism (SSM), which is responsible for banking supervision in the participating Member States, such as Ireland. Under the SSM, the European Central Bank (the ECB) has exclusive competence in respect of certain aspects of the prudential regulation of Irish banks, including the granting and withdrawal of banking licences and the assessment of notifications of the acquisition and disposal of qualifying holdings in banks (except in the case of a bank resolution). The ECB also directly supervises "significant" banks (SIs), while the CBI directly supervises "less significant" banks (LSIs), subject to ECB oversight. The SSM sets out criteria for determining SIs and LSIs.

### Other Regulatory Bodies

Other regulatory bodies that are also relevant to Irish banks include the Office of the Director of Corporate Enforcement, the Competition and Consumer Protection Commission, which regulates competition and consumer affairs, the Data Protection Commission, which enforces data protection legislation in Ireland, and the Financial Services and Pensions Ombudsman, which handles complaints from consumers of financial services.

# 2. Authorisation

## 2.1 Licences and Application Process

### Banking Business

Section 7(1) of the 1971 Act prohibits the carrying on of "banking business" or accepting deposits or other repayable funds from the public without a banking licence. The definition of "banking business" is any business that consists of or includes receiving money on the person's own account from members of the public either on deposit or as repayable funds and the granting of credits on own account (subject to certain exceptions).

While the 1971 Act does not define "repayable funds", section 2(2) of the Central Bank Act 1997 defines "deposit" for the purposes of the Central Bank Acts as "a sum of money accepted on terms under which it is repayable with or without interest whether on demand or on notice or at a fixed or determinable future date."

A person may apply for a banking licence to be granted under Section 9 of the 1971 Act. Since the introduction of the SSM, the ECB is the competent authority for the granting of the licence.

It is also possible to apply for authorisation under Section 9A of the 1971 Act for an Irish branch of a bank that is authorised in a third country (ie, a non-EEA country).

#### *Holding oneself out as a banker*

Section 7(1) of the 1971 Act also restricts persons from holding themselves out or representing themselves as a banker, or from carrying on banking business unless appropriately authorised.

The 1971 Act provides that, where a person carries out business under a name that includes the words "bank", "banker" or "banking", or any word which is a variant, derivative or translation of or is analogous to those words, or uses any advertisement, circular, business card or other document that includes such words, he holds himself out or represents himself as conducting or being willing to conduct banking business.

#### Permitted Activities
A banking licence permits the holder to engage in a broad range of business, including deposit taking, lending, issuing e-money, payment services and investment services and activities regulated by the Markets in Financial Instruments Directive (2014/33/EU) (MiFID II).

#### Application Process
In practice, the application process for a bank licence typically begins with a preliminary engagement phase, whereby the applicant will often have meetings or calls with the CBI and submit a detailed proposal for their application.

Following this, the applicant will prepare its formal application. The application pack requires extensive detail regarding all material areas of the applicant's proposed business, as set out in the CBI's "Checklist for completing and submitting Bank Licence Applications under Section 9 of the Central Bank Act 1971", which is available on the CBI's website.

The information required includes:

- details of the applicant company's parent or group and beneficial ownership;
- objectives and proposed operations;
- details of the proposed bank's "Heart and Mind" being in Ireland;
- details of internal controls;
- capital and solvency;
- details of information technology and business continuity planning; and
- details of recovery and resolution planning.

Following the receipt of the application, the CBI will assess the application, in conjunction with the ECB. The process is iterative and typically involves multiple rounds of extensive comments and queries from the regulators.

Following the completion of the iterative query stage, the ECB will determine whether to grant a licence. The timeline for this entire process generally takes between 12 and 18 months. Where a licence is granted, it may be subject to specific conditions.

There is no fee for submitting a bank application, but banks are subject to a number of ongoing levies.

#### Passporting
Under the CRD IV mutual recognition provisions, Irish banks can both provide services on a freedom of services basis and establish a branch on a freedom of establishment basis across the EEA, subject to completing the necessary passporting processes.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

#### Requirements Governing Change in Control
The requirements in relation to the acquisition and disposal of interests in banks are set out in Chapter 2 of Part 3 of the CRD IV Regulations. The CRD IV Regulations provide that the prior approval of the ECB is required in advance of any proposed acquisition of a qualifying holding in a bank.

A "qualifying holding" is defined as a direct or indirect holding in an undertaking which represents 10% 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. Notification is also required in respect of direct or indirect holding increases above a prescribed percentage of 20%, 33% or 50%.

There are no restrictions on private ownership or geographical restrictions on foreign ownership of Irish banks. However, the CBI has expressed preferences in the past that banks not be owned or controlled by single private individuals or that ownership of banks should not be "stacked" under insurance undertakings. Prior ownership experience of banks or other financial institutions will be an advantage in applying for approval of an acquisition of a qualifying holding.

The CRD IV Regulations provide that an application to the Irish High Court may be made to remedy a situation where a qualifying holding was inadvertently acquired without the prior approval of the ECB.

#### The Nature of the Regulatory Filings
Notification of the proposed acquisition of a qualifying holding is made to the CBI using the CBI's Acquiring Transaction Notification Form (ATNF). The CBI, in turn, will liaise with the ECB, which is the competent authority under the SSM for the approval of acquisitions of or increases in qualifying holdings in respect of Irish authorised banks.

The maximum total period for assessment of an acquiring transaction notification is 90 working days from the receipt of a complete application. The CBI can reject notifications as not complete at the outset of the process, and so in practice this process can take longer. The CBI advises that pre-application engagement and the submission of notification and supporting documentation in draft form can help minimise the risk of a notification being deemed "incomplete", thereby delaying the approval process.

The CBI also requires any proposed acquirers to take note of the content of the May 2017 Joint Committee of the European Supervisory Authorities (which includes the European Banking Authority – EBA) "Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the banking, insurance and securities sectors".

The content required to complete an ATNF includes details of:

- the proposed acquisition and impact on the target;
- the proposed acquirers and financing of the proposed acquisition;
- the rationale for the proposed acquisition; and
- details of the new proposed group structure and any impact on supervision.

A business plan for the target entity may also be required with the notification, detailing the proposed acquirers' expected activities/performance and financial projections over three years.

The CBI may also seek comfort from a proposed acquirer of a majority stake in an Irish bank that the proposed acquirer will provide such financial support as is necessary for the Irish bank to continue to meet its regulatory obligations.

## 4. Supervision

### 4.1 Corporate Governance Requirements

The corporate governance requirements applicable to Irish banks include those set out in the CBI Corporate Governance Requirements for Credit Institutions 2015 (CBI Requirements) and the CRD IV provisions in respect of corporate governance.

#### CBI Requirements

The CBI Requirements provide that all Irish banks must have robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks to which they are or might be exposed, and adequate internal control mechanisms. The governance structure put in place must be sufficiently sophisticated to ensure that there is effective oversight of the activities of the institution, taking into consideration the nature, scale and complexity of the business being conducted.

The CBI Requirements are prescriptive, imposing minimum standards in relation to corporate governance, including the composition, role and conduct of the board of directors and the establishment of certain board committees, and also setting out requirements in relation to risk management.

An Irish bank is required to have at least five directors (seven if it is designated as having a High Impact under the CBI's Probability Risk and Impact System (PRISM)). The board is required to have a majority of independent non-executive directors (INED), although where a bank is part of a group, the majority of the board may also be composed of group directors, provided that the bank has at least two INEDs (or three INEDs where the bank is designated as High Impact).

#### CRD IV

The CRD IV Regulations set out a number of high-level rules in relation to the governance of banks. The EBA has built upon these requirements in its Guidelines on internal governance (EBA/GL/2017/11) (EBA IG Guidelines). The EBA IG Guidelines are stated to specify the internal governance arrangements, processes and mechanisms that banks and investment firms must implement in accordance with Article 74(1) of CRD IV to ensure effective and prudent management of the institution.

The EBA IG Guidelines apply in relation to governance arrangements such as organisational structure, lines of responsibility, risk identification and management and the internal control framework. Guidance is given in relation to the role of the management body and its responsibilities, as well as the role of board committees and internal control functions. Arrangements in relation to risk management, outsourcing and business continuity are also addressed.

#### Recent Developments

Corporate governance continues to be an area of focus for the CBI. This has been evident in recent publications and supervisory focuses on areas including behaviour and culture, conduct risk, outsourcing and individual accountability.

The Irish Bank Culture Board was also established in 2019 by the five retail banks operating in Ireland, with the aim of rebuilding trust in the sector by demonstrating a change in behaviour and overall culture.

## 4.2 Registration and Oversight of Senior Management

### Fitness and Probity Regime

The CBI's Fitness and Probity regime (F&P Regime), which was established under the 2010 Act, applies to persons in certain senior positions in Irish regulated financial service providers (RFSPs), including banks.

### Controlled Functions

The F&P Regime applies to persons performing certain prescribed "controlled functions" (CFs) and "pre-approval controlled functions" (PCFs). PCFs are a sub-set of CFs and include directors, chairs of the board and committees, the chief executive and heads of certain internal control functions, amongst other functions.

An RFSP must not permit a person to perform a CF or PCF unless it is satisfied on reasonable grounds that the person complies with the CBI's Standards of Fitness and Probity (Standards) and the person has agreed to comply with the Standards. The Standards require a person: (a) to be competent and capable; (b) to be honest and ethical, and to act with integrity; and (c) to be financially sound. In order to be satisfied the person complies with the Standards, due diligence must be undertaken by the RFSP.

Irish banks are also subject to the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders (Suitability Guidelines), as well as CRD IV requirements.

### Pre-approval for PCFs

A person cannot be appointed to a PCF position unless the appointment has been approved by the CBI. For SIs, the approval of the ECB is required for members of the management body. This is also the case for members of the management body of any new bank.

PCF applicants are required to submit an individual questionnaire (IQ) to the CBI, which sets out details of their professional qualifications and employment history, and includes various confirmations from both the applicant individual and the RFSP. The CBI/ECB may interview candidates for certain PCF roles and this is increasingly becoming the norm for bank board members and certain other senior PCFs.

The ECB has published a Guide to Fit and Proper Assessments for its fitness and probity assessments, which are conducted in accordance with the Suitability Guidelines.

### Accountability

CF and PCF holders may be the subject of an investigation or required to comply with an evidentiary notice, or may be the subject of a suspension notice or a prohibition under the 2010 Act. Applicants for PCF roles are also not guaranteed to receive approval.

The CBI operates an administrative sanctions regime in order to take enforcement actions in relation to RFSPs. Persons involved in the management of an RFSP may be subject to sanctions in certain circumstances.

The CBI has proposed reforms that would strengthen its toolkit in relation to individual accountability (see **10. Horizon Scanning**).

## 4.3 Remuneration Requirements

Irish banks are subject to remuneration rules under both the CBI Requirements and the CRD IV Regulations, and must comply with certain principles in a manner and to the extent that is appropriate to their size and internal organisation and to the nature, scope and complexity of their activities.

The EBA "Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of CRD IV" (EBA Remuneration Guidelines) also apply to banks, covering issues including the governance process for remuneration policies and the application of remuneration requirements in a group context. The CBI issued a policy statement on 31 January 2017 on the CBI's approach to proportionality relating to the payout process applicable to variable remuneration, confirming its intention to comply with the EBA Remuneration Guidelines and future European developments.

Banks that are classified as SIs are required to have a remuneration committee that complies with the requirements of the CRD IV Regulations. Banks with a High Impact PRISM rating are required to have a remuneration committee that complies with the CBI Requirements.

The CRD IV Regulations require banks to have a remuneration policy that is in line with its business strategy, objectives and long-term interests, is consistent with and promotes sound and effective risk management, and does not encourage risk-taking that exceeds the level of tolerated risk of the institution. The board is responsible for overseeing the implementation of the remuneration policy and should periodically review its general principles. Banks should review their remuneration policies at least annually. The CRD IV Regulations also impose disclosure requirements relating to remuneration policies and practices.

Banks should also ensure that the remuneration of "control function" employees (note this is distinct from CF as defined in **4.2 Registration and Oversight of Senior Management**) is not linked to the performance of any business areas they control, and that the remuneration of senior risk and compliance employees is suitably overseen. In respect of certain employees whose professional activities have a material impact on the risk profile of the institution, including senior management, risk takers and heads of control functions, banks are subject to extensive rules regarding variable remuneration. These rules include a "bonus cap", which limits variable remuneration at 100% of fixed remuneration (or 200% with shareholder approval).

Breach of the CBI Requirements and/or the CRD IV Regulations is an offence and may be grounds for an enforcement action by the CBI under its administrative sanctions regime, which can result in fines being imposed.

The upcoming implementation of CRD V will introduce additional remuneration requirements (see 10. **Horizon Scanning**).

## 5. AML/KYC

### 5.1 AML and CTF Requirements

#### Legal Framework

The primary anti-money laundering (AML) and counter-terrorist financing (CTF) legislation applicable to Irish banks is the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 (CJA 2010), which transposed the Third EU Anti-Money Laundering Directive (2005/60/EC) and the Fourth EU Anti-Money Laundering Directive ((EU) 2015/849) into Irish law. Draft legislation to amend the CJA 2010 for the purposes of implementing the Fifth EU Anti-Money Laundering Directive (2018/843/EU) (5AMLD) was published in September 2020 and is pending (see 10. **Horizon Scanning**).

The CJA 2010 imposes a range of obligations on banks, including obligations to:

- conduct a business risk assessment;
- conduct risk-sensitive due diligence on customers and their beneficial owners both at on-boarding and on an ongoing basis;
- report suspicious activity to the relevant authorities – ie, the Financial Intelligence Unit Ireland (the Irish police) and the Irish Revenue Commissioners;
- implement internal policies, controls and procedures to prevent and detect the commission of money laundering (ML) and terrorist financing (TF);
- provide AML/CTF training to persons involved in the conduct of the bank's business; and
- keep records in relation to business risk assessments, customer due diligence and customer transactions.

The CBI published its AML/CTF Guidelines for the Financial Sector (AML Guidelines) in September 2019 to assist firms in understanding their obligations under the CJA 2010. The AML Guidelines set out the expectations of the CBI regarding the factors that firms should take into account when identifying, assessing and managing ML and TF risks, and also emphasises the importance of firms having regard to AML/CTF guidance published by the Financial Action Task Force and European supervisory authorities.

In addition to the CJA 2010, Irish banks are also required to comply with the various international financial sanctions that emanate from the EU and the United Nations, and with Regulation (EU) 2015/847, which deals with information requirements regarding wire transfers.

#### Regulatory Supervision and Enforcement

Under the CJA 2010, the CBI is the relevant competent authority in Ireland for the monitoring and supervision of banks' compliance with AML/CTF obligations. The CBI implements a risk-based approach to AML/CTF supervision such that the extent of supervision of a given firm is commensurate with the CBI's assessment of ML/TF risk within the firm. The retail banking sector is considered by the CBI to be a high-risk sector, with the non-retail banking sector considered to be a medium-high risk sector. An individual firm's ML/TF risk rating will be informed by the CBI's risk rating of the sector and its supervisory engagements with the firm, such as inspections.

The CBI is empowered to take measures that are reasonably necessary to ensure that firms comply with the provisions of the CJA 2010. This may include the CBI issuing a risk mitigation programme to a firm to address identified shortcomings in the firm's AML/CTF framework. The CBI also has the power to administer sanctions against banks for breaches of the CJA 2010 under its administrative sanctions regime, which can result in fines being imposed.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

Ireland has transposed the Deposit Guarantee Schemes Directive (2014/49/EU) (DGS Directive) into domestic law through the European Union (Deposit Guarantee Schemes) Regulations 2015 (DGS Regulations), which govern the operation of a deposit guarantee scheme (DGS) for "eligible deposits" at Irish banks. Irish banks are not allowed to accept deposits without being members of the DGS.

The CBI is the designated authority for the purposes of the DGS Directive, and is responsible for the maintenance and ongoing supervision of the DGS and for ensuring that it has sound and transparent governance practices in place. The CBI is required to produce an annual report on the activities of the DGS.

The DGS provides protection to eligible deposits, which includes deposits belonging to individuals, companies, partnerships, clubs and associations. The eligible deposits that may be protected by the DGS include current accounts, savings accounts, demand, notices and fixed-term deposit accounts and share accounts. The deposit element of structured deposits/tracker bonds may also be eligible if the deposit element is repayable at par.

Certain specified categories are not eligible deposits. These include deposits of "financial institutions" as defined under the CRR – and including insurance undertakings, collective investment schemes, MiFID II investment firms and other banks (subject to certain conditions). Deposits of public authorities, debt securities issued by banks and liabilities arising out of its own acceptances and promissory notes are also not eligible deposits, and a bank's "own funds" for the purposes of the CRR are also not covered.

The coverage level for aggregate eligible deposits for each depositor is EUR100,000. In certain specified circumstances, a depositor may be covered for aggregate deposits up to a level of EUR1 million as a "temporary high balance". The DGS Regulations set out detailed provisions as to how a depositor's aggregate deposits are to be calculated.

Examples of circumstances that give rise to increased "temporary high balance" cover include where monies are deposited in preparation for the purchase of – or which represent the proceeds of a sale of – a private residential property, where the monies deposited represent certain insurance or compensation payments, or where funds are held by a depositor in his or her capacity as the personal representative of a deceased person for the purpose of realising and administering the deceased's estate. Subject to certain exceptions, this higher level of cover will be available to depositors for a period of six months after the relevant amount has been credited or from the moment when such deposits become legally transferable.

The DGS Regulations provide that the DGS is funded by participating banks. As the designated authority, the CBI is responsible for ensuring that it has adequate systems in place to determine the potential liabilities of this fund. The CBI identifies a target level for the fund and requires all banks that hold eligible deposits to pay contributions to the fund. The fund must hold at least 0.8% of the amount of eligible deposits of all banks authorised in the State.

A bank's required contribution to the DGS is calculated primarily by reference to the proportion of eligible deposits it holds, and the DGS Regulations set out prescriptive provisions regarding how these obligations are to be calculated and levied.

The Irish DGS protects eligible deposits held at EEA branches of Irish banks. Deposits held with other EEA banks should be protected under the relevant other EEA bank's home country deposit protection scheme.

In November 2015, the European Commission proposed a European Deposit Insurance Scheme, which, if established, would form part of the third pillar of the EU's Banking Union. However, this proposal is subject to ongoing political debate.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

Irish banks owe a duty of confidentiality to their customers. The duty of confidentiality has its origins in the common law and is an implied term in all contracts between banks and their customers. For the purpose of this duty, "customers" includes both natural and legal persons. There has also been limited judicial commentary to the effect that the Irish constitutional right to privacy may encompass a right to confidentiality in relation to banking affairs.

The duty of confidentiality is a broad one and provides that, once a contractual relationship exists between a bank and a customer, the bank must not divulge to third parties any information acquired by the bank during, or by reason of, its relationship with the customer, without the express or implied consent of the customer. Banks must also ensure that their employees and agents do not breach the duty.

In practice, the duty of confidentiality applies to information related to the state of the customer's account or the amount of the balance, the securities offered to and held by the customer, the extent and frequency of transactions and any information obtained by the bank as a consequence of its relationship with the customer. The duty of confidentiality continues to apply when the account is closed or ceases to be active.

Given the wide and increasing range of services offered by banks and RFSPs, where any business of a kind normally carried on by a bank is carried out, it is prudent to presume the imposition of this duty of confidentiality.

The duty of confidentiality is not absolute and the Irish courts have confirmed the existence of a number of qualifications and exemptions to the duty of confidentiality, including where:

- disclosure is under compulsion of law;
- there is a duty to the public to disclose;
- the interests of the bank require disclosure; or
- the disclosure is made by the express or implied consent of the customer.

Irish statutes contain a number of express statutory exceptions to the duty of confidentiality. These exemptions are included in the Companies Act 2014, the CJA 2010, criminal justice legislation and credit reporting legislation, as well as the law of evidence, including court rules providing for discovery orders.

A court or judge may authorise a member of the Irish police force to inspect bank records to investigate an indictable offence, where the court or judge is satisfied that there are reasonable grounds for believing that such an offence has been committed and the relevant material is likely to be of substantial value to the investigation.

In addition, by virtue of their statutory powers, the CBI and the Revenue Commissioners have the ability to inspect customer accounts in certain circumstances.

Where the customer consents to disclosure, the duty may be dis-applied; this is relatively common where a third party seeks a reference or statement from a bank with the customer's consent. It is best practice to obtain the customer's prior written authorisation in these circumstances.

Where the duty of confidentiality is breached, the customer is entitled to seek damages, which may include aggravated damages.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

The prudential requirements applicable to Irish banks, including in relation to capital and liquidity, emanate from EU legislation that is itself heavily influenced by international standards.

The current prudential requirements applicable to Irish and other EEA banks are set out in CRD IV and the CRR, as well as secondary EU legislation. This framework largely addresses the requirements of the "Basel III" reforms that were finalised in December 2010. More recent standards of the Basel Committee on Banking Supervision and the Financial Stability Board (FSB) will be implemented by CRD V and the CRR II (see 10. **Horizon Scanning**). The EU rules also contain bespoke requirements to address particular concerns of the EU Member States.

### Initial Capital

Under the 1971 Act, Irish banks must hold initial capital of at least EUR5 million before the CBI will propose to the ECB that a banking licence should be granted. In some cases, initial capital can instead be a minimum of EUR1 million.

### Capital Requirements – Pillar I

The CRR sets out the requirement for banks to maintain a minimum quantity of regulatory capital and rules governing the quality of that capital. The quality of regulatory capital is considered by reference to two categories:

- Tier 1 Capital, which is divided into (a) Core Equity Tier 1 (CET1) and (b) Additional Tier 1 Capital; and
- Tier 2 Capital.

CET1 includes ordinary shares and reserves, and is the highest quality capital. There are eligibility criteria and deductions that must be followed to calculate the instruments that qualify for each tier.

The minimum capital requirement is a percentage of a bank's risk weighted assets (RWAs). The calculation of a bank's RWAs involves allocating a weighting to the value of an asset relative to the risk of incurring losses. Banks can use the Standardised Approach (with standardised weightings) or the Internal Ratings Based approach (where the bank calculates its own risk weights, subject to approval) in assessing credit risk and calculating risk weights.

The CRR requires maintenance of the following minimum capital ratios:

- regulatory capital of 8% of RWAs;
- CET1 of 4.5% of RWAs; and
- Tier 1 Capital of 6% of RWAs.

### Capital Buffers

The following four buffers are provided for under CRD IV:

- a capital conservation buffer, which requires banks to hold CET1 equal to a further 2.5% of RWAs, in addition to CET1 amounting to 4.5% of RWAs referenced above. There are restrictions on distributions where the buffer is not maintained;
- a counter-cyclical buffer (CCyB), based on total risk weighted exposures of a bank and the CCyB rates applicable to those exposures in the jurisdiction where they are located.

This also comes with capital maintenance requirements. The CCyB rate for Irish exposures is set quarterly by the CBI and applies to all EU banks with exposures to Irish counterparties. The CCyB aims to make the banking system more resilient and less pro-cyclical, and to support the supply of credit during a downtown, at times when the CCyB is released;

- a buffer applicable to global systemically important institutions (G-SIIs) and one applicable to other systemically important institutions (O-SIIs). Six banks regulated by the CBI and the ECB are currently subject to an O-SII buffer ranging from 0.5% to 1.5% (CBI's 2019 assessment); and
- a systemic risk buffer – the CBI has requested that the Irish legislature adopt this national discretion so that it would be available in Ireland, but implementing legislation is currently outstanding.

#### Pillar II Capital

The CBI has the power to apply additional capital requirements to Irish banks on a case-by-case basis. Any additional requirements will be based on the CBI's assessment under its supervisory review and evaluation process, which looks at the specific risks of the firm. Non-binding guidance may also be issued to a bank in respect of further capital it is expected to hold. CRD V will make amendments to the process for the imposition of capital under Pillar II.

#### Liquidity

The CRD IV/CRR framework provides for two liquidity ratios. The liquidity coverage ratio (LCR) requires banks to hold high-quality unencumbered liquid assets, which must be sufficient to meet net cash outflows under a 30-day stress scenario.

A separate net stable funding ratio (NSFR) has been introduced under the CRR to address liquidity mismatches. This aims to ensure that the level of stable funding available to a bank is aligned with the level of funding it requires over the longer term, based on the liquidity risk profiles of assets and off-balance sheet exposures. CRR II amendments to the CRR will set out a minimum level of stable funding for the first time.

#### MREL

Currently, under BRRD banks must comply with a minimum requirement for own funds and eligible liabilities (MREL). This is a requirement to ensure a bank can continue to perform certain critical functions even after a resolution event – the MREL should assist the bank in absorbing losses and restore its capital so that the bail-in resolution tool can be applied effectively. Under BRRD II, a number of changes will be introduced to align MREL with the FSB's standard relating to total loss absorbing capacity (TLAC). In addition, the CRR II will amend the CRR to implement the TLAC standard and apply it to G-SIIs.

#### Other

The CRD IV Regulations and the CRR provide other measures to address risks applicable to banks. These include measures in relation to credit valuation adjustment, a leverage ratio, disclosure requirements, reporting requirements, governance and remuneration requirements, credit risk adjustment and the ability of regulatory authorities to impose stricter macro-prudential measures.

The CBI has also issued a Policy on Management of Country Risk, August 2013, and a regulatory document entitled "Impairment Provisions for Credit Exposures – 26 October 2005", with which banks are required to comply.

#### COVID-19 Flexibility Measures

The CBI and the ECB have made a number of announcements in relation to the application of capital and liquidity requirements in light of the COVID-19 pandemic.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

The legal and regulatory framework governing the insolvency, recovery and resolution of banks in Ireland has undergone significant development since the global financial crisis of 2007/8, when Ireland hastily implemented emergency legislation to address issues affecting domestic institutions. Since then, the EU has adopted BRRD and the Single Resolution Mechanism (SRM) Regulation (806/2014) (SRM Regulation), which provide an EU framework for the recovery and, where necessary, resolution of EU banks.

#### Insolvency

One of the ways in which a failing bank can be addressed is through a liquidation process. In its document entitled "Central Bank of Ireland's Approach to Resolution for Banks and Investment Firms (First Edition) April 2019" (Approach Paper), the CBI comments that, in fact, the most likely method for the majority of failing institutions is through a CBI-involved winding-up (liquidation) procedure.

The Central Bank and Credit Institutions (Resolution) Act 2011 (Resolution Act) provides that the Irish Companies Acts will apply to the winding-up of an Irish bank. However, the CBI has an important role under the Resolution Act. No person other than the CBI can present a petition to the High Court to wind up a bank, unless they have given the CBI notice and the CBI has confirmed that it does not object. In the latter case, the CBI will be a notice party to court applications and may make representations in court.

The Resolution Act sets out a number of specific grounds under which the CBI may present a petition for a winding-up order, such as where:

- it would be in the public interest;
- the bank is unable to meet obligations to creditors;
- the bank has failed to comply with a CBI direction;
- the bank's licence has been revoked; or
- it is in the interests of depositors.

Under the Resolution Act, only a liquidator approved by the CBI may be appointed. Objectives for the appointed liquidators are set out in the legislation, with the protection of eligible depositors under the DGS being a priority.

### Recovery and Resolution

BRRD and the SRM Regulation set out an alternative mechanism to resolve failing banks in a more orderly way, and seek to implement the original "Key Attributes of Effective Resolution Regimes for Financial Institutions" published by the FSB. BRRD provides authorities with tools to intervene at an early stage and in a swift manner in relation to a failing institution, to ensure the continuity of critical functions and minimise the impact of the institution's failure on the economy and financial system.

As Ireland is part of the SSM, the SRM is applicable to Irish banks, and the SRM Regulation is directly applicable in Ireland.

The CBI is designated as the national resolution authority under the SRM and the national competent authority under the SSM. Broadly speaking, the Single Resolution Board (SRB) has responsibility in relation to the resolution of SIs or institutions subject to direct ECB oversight, and the CBI will have responsibility for the key resolution processes for LSIs, subject to SRB oversight.

### Resolution Tools and Powers

The framework includes the following elements:

- in order to prepare for or prevent failure:
  - (a) recovery plans are to be prepared by banks, setting out measures to be taken by the institution to restore its financial position following a significant deterioration of its financial position;
  - (b) resolution plans are to be prepared by resolution authorities, setting out the resolution options for the particular institution; and
  - (c) powers are available to remove impediments to resolution;
- powers for authorities to take steps at an early stage, including requiring the implementation of recovery plans or replacing management; and
- where certain conditions are met, the availability of resolution tools to manage the resolution of a failing institution, including the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool. The resolution tools and associated resolution powers available are subject to procedural requirements.

Resolution authorities are also afforded write-down and conversion powers in respect of certain capital instruments. These can be implemented as part of a resolution action or separately, where certain conditions are met.

In its Approach Paper, the CBI has commented that resolution tools would generally be used where, for example, a bank's failure could cause financial instability or disrupt critical functions. Resolution tools would be used by the CBI where there is no viable alternative supervisory or private sector solution and the CBI considers resolution to be in the public interest.

Resolution funds have been established in Ireland and at the EU level, in order to provide funding for the cost of resolution.

### Protection for Depositors

The DGS protects eligible depositors in the event of a bank authorised by the CBI being unable to repay deposits. Objectives related to the protection of deposits eligible under the DGS are also built into both the liquidation and resolution frameworks.

DGS eligible deposits up to an amount of EUR100,000 are exempted from bearing losses in a resolution process. Eligible deposits of natural persons and small and medium enterprises exceeding EUR100,000 receive a preferred status over certain other senior unsecured liabilities in a resolution process. Amendments have also been made to the Irish Companies Act 2014 to provide for preference to certain depositors in a liquidation of a BRRD institution so as to implement the Bank Creditor Hierarchy Directive ((EU) 2017/2399).

### Looking Forward

Directive (EU) 2019/879 (BRRD II) is to be transposed into Irish law by 28 December 2020 and extensively amends BRRD (see 10. **Horizon Scanning**).

## 10. Horizon Scanning

### 10.1 Regulatory Developments

#### Senior Executive Accountability Regime

Culture within the Irish financial services industry has been a key issue for the CBI and RFSPs in the wake of a number of instances of banks and firms engaging in practices and activities that did not meet the standards expected of the sector, such as overcharging customers. In 2018, the CBI published a report entitled "Behaviour and Culture of the Irish Retail Banks", which identified that consumer-focused cultures in banks remained underdeveloped.

To support positive cultural changes, the CBI recommended the introduction of an Individual Accountability Framework comprising a Senior Executive Accountability Regime (SEAR), standards of conduct for RFSPs and their staff, and enhancements to the existing F&P Regime and to the existing administrative sanctions regime. While draft legislation was expected this year, this remains outstanding.

The introduction of SEAR will require firms and those acting in senior executive functions (SEFs) to take a number of steps in order to ensure compliance. The CBI has indicated that SEFs will include board members, executives reporting directly to the board and heads of critical business areas.

The CBI indicates that SEFs would be similar to PCFs within the existing F&P Regime. Certain SEF roles may be mandatory while others would be discretionary and applied to firms on a case-by-case basis. The list of responsibilities of a firm would be determined based on the nature, scale and complexity of each firm. Each SEF would have particular responsibilities, with the CBI prescribing mandatory functions and responsibilities to be fulfilled by a SEF within an in-scope firm.

Under the SEAR proposals, in-scope firms would also be required to produce a "Responsibility Map" detailing the key management and governance arrangements within the firm. Statements of Responsibilities would also be required, setting out where responsibility lies amongst SEFs for fulfilling the prescribed obligations of firms. The Statements of Responsibilities would be required to be submitted to the CBI, which would assist the CBI in monitoring compliance and assessing the fitness and probity of SEFs within in-scope firms.

The CBI's reform proposals also include the consolidation into one single legislative act of the "full suite of relevant inspection and investigations powers" of regulatory agencies to assist in the elimination of issues caused by the currently fragmented nature of the framework. Furthermore, it is recommended that provision be made for the CBI to "pursue individuals directly for their misconduct rather than only where they are proven to have participated in a firm's wrongdoing" and that, "as with other requirements, a breach of the Conduct Standards would be subject to direct enforcement action."

### Fifth Anti-Money Laundering Directive

5AMLD requires EU Member States to implement its provisions into domestic law by 10 January 2020. Ireland did not meet this deadline, and 5AMLD has not yet been implemented into Irish law. On 8 September 2020, the Irish Government published draft legislation that seeks to transpose 5AMLD into Irish law by amending the CJA 2010 (2020 Bill).

As currently drafted, the 2020 Billproposes to make a number of amendments to the CJA 2010 that are of relevance to banks operating in Ireland, certain of which are set out below.

#### *Beneficial ownership verification*

The 2020 Bill seeks to introduce requirements for designated persons (which includes banks) to verify the beneficial ownership of customers that are subject to beneficial ownership disclosure requirements.

#### *Enhanced customer due diligence*

The 2020 Bill provides elaboration on designated persons' enhanced customer due diligence obligations in respect of customers in high-risk non-EEA jurisdictions.

Designated persons must obtain additional information on the customer and beneficial owner (including source of funds and source of wealth), the intended nature of the business relationship and reasons for the intended or performed transactions. Senior management approval is also required for establishing or continuing the business relationship, and designated persons must conduct enhanced monitoring of the business relationship by increasing the number and timing of controls applied and selecting patterns of transactions that need further examination.

#### *Politically exposed persons*

The 2020 Bill requires designated persons to monitor any politically exposed person (PEP) "for as long as is reasonably required to take into account the continuing risk posed by that person and until such time as that person is deemed to pose no further risk specific to politically exposed persons."

The 2020 Bill also expands the definition of a PEP to include "any individual performing a prescribed function." The 2020 Bill allows for the Irish Government to issue guidelines to the relevant authorities, to which those authorities must have regard in respect of functions in the State that may be considered to be prominent public functions.

#### *Correspondent banking relationship*

The 2020 Bill modifies the restrictions on financial institutions entering into correspondent relationships with non-EEA financial institutions, subject to certain requirements being met, to apply to correspondent relationships "involving the execution of payments."

### CRD V/CRR II

CRD V and the CRR II were published in June 2019 and form part of the banking reform package proposed by the EU Commission in November 2016.

CRD V must be transposed into Irish law by 28 December 2020, and has staggered implementation dates: certain provisions are to be applied from 28 December 2020, 28 June 2021 and 1 January 2022 respectively. While CRD V has amended CRD IV, Ireland has not yet amended the CRD IV Regulations to implement CRD V into Irish domestic law.

The CRR II substantially amends the CRR and also amends the European Markets Infrastructure Regulation (648/2012/EU). The majority of the provisions of the CRR II are applicable from 28 June 2021, with certain provisions applicable both before and after that date. CRD V and the CRR II mandate that, as part of their implementation, the EBA is to develop certain implementing and regulatory technical standards and guidelines.

The CRR II introduces two new categories of institutions – "large institutions" and "small and non-complex institutions" – and sets out criteria for determining these categories. Certain flexibility in respect of the provisions that apply to various categories of institutions is included in the CRR II, to ensure that the relevant requirements are applied in a more proportionate way.

CRD V and the CRR II implement various international prudential standards in the EU agreed as part of the Basel III package, including on areas such as the leverage ratio, net stable funding ratio, TLAC and large exposures. CRD V and the CRR II also introduce EU-specific amendments that are not driven by Basel III or other international standards, including on topics such as encouraging lending to small and medium enterprises, remuneration and information sharing between competent authorities for AML supervision purposes.

The CRD V amendments to the CRD IV remuneration provisions include additional requirements relating to gender-neutral remuneration. CRD V amends CRD IV to include a definition of gender-neutral remuneration policy as "a remuneration policy based on equal pay for male and female workers for equal work or work of equal value."

### BRRD II

In addition to the introduction of CRD V, as a further element of the EU banking reform package, BRRD will be amended by BRRD II, which entered into force on 27 June 2019 and must be transposed into Member State law by 28 December 2020.

The SRM Regulation will also be amended by Regulation (EU) 2019/877 (SRM Regulation II), which will apply from 28 December 2020.

Certain transitional periods will apply in relation to specific requirements relating to the application of the revised requirements introduced by these changes. The deadline for in-scope banks to comply with the revised MREL requirements is 1 January 2024, although certain requirements for G-SIIs and "top-tier" banks will be introduced earlier, on 1 January 2022.

Under BRRD II, the MREL requirement (see **8.1 Capital, Liquidity and Related Risk Control Requirements**) will be substantially revised in order to reflect the FSB's standard relating to TLAC. The SRM Regulation II amends the SRM Regulation for the same purpose. The CRR II will also amend the CRR to adopt the TLAC.

In addition, BRRD II introduces new requirements around resolution planning on a "resolution group" and "resolution entity" basis, and introduces additional powers for resolution authorities, including a moratorium power for bank liabilities.

Other changes include amendments to Article 55 of BRRD, which requires certain contracts to include a provision recognising the bail-in powers under BRRD and the introduction of the contractual recognition of resolution stay powers. The resolution toolkit for resolution authorities is also extended to include a moratorium tool.

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# JAPAN


## Law and Practice

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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Principal Laws and Regulations

*Banking Act*

The principal laws and regulations governing the banking sector are the Banking Act (Act No. 59 of 1981) and the subordinate regulations enacted thereunder, including the Order for Enforcement of the Banking Act (Cabinet Order No. 40 of 1982) and the Regulation for Enforcement of the Banking Act (Ministry of Finance Order No. 10 of 1982).

The Banking Act defines banking as the business of conducting both acceptance of deposits and lending of funds, or providing money transfer services. Any person wishing to engage in banking must obtain a licence and will be subject to regulations under the Banking Act, including:

- restrictions on the scope of business by banks;
- restrictions on the scope of business by banks' subsidiaries;
- code of conduct;
- governance requirements;
- capital adequacy requirements;
- accounting (including disclosure requirements);
- regulations on major shareholders of banks; and
- regulations on bank holding companies.

The purpose of these regulations under the Banking Act is to "preserve the credibility of banking services in view of their public nature; to achieve the sound and appropriate management of banking services in order to ensure protection for depositors and facilitate the smooth functioning of financial services; and to thereby contribute to the sound development of the national economy" (Article 1 of the Banking Act).

*Financial Instruments and Exchange Act*

Contrary to "universal banks" in Europe, banks in Japan are generally prohibited from engaging in securities business, but this prohibition has gradually been relaxed, and the scope of securities business that banks are allowed to conduct has gradually been expanded. Banks can also conduct certain securities business through their subsidiaries. Securities business (whether conducted by banks themselves or through their subsidiaries) is regulated by the Financial Instruments and Exchange Act (Act No. 25 of 1948).

### Regulators

*Financial Services Agency*

The principal regulator of the banking sector is the Financial Services Agency (FSA), which is authorised under the Banking Act to supervise banks. The authority of the FSA includes:

- conducting on-site inspections and off-site monitoring;
- issuing reporting orders, business improvement orders or business suspension orders; and
- revoking banking licences.

The FSA issues supervisory guidelines on the interpretation of laws and regulations. Historically, the FSA also issued an inspection manual to be used as a checklist in its on-site inspections, but this manual was abolished in 2019 in an effort to transform the FSA's supervisory approaches into more substantive, forward-looking and holistic analysis and judgment. The FSA has instead issued certain principles and theme-specific reports to announce its supervisory policies.

The FSA also has authority under the Financial Instruments and Exchange Act to supervise securities business conducted by banks or their subsidiaries. A portion of the FSA's authority to conduct inspections of securities business is delegated to the Securities and Exchange Surveillance Commission.

*Bank of Japan*

The Bank of Japan (BOJ) is the central bank of Japan. It does not have regulatory authority under the Banking Act, but it has a right to conduct on-site examinations of banks under the agreements that it enters into with the banks when opening accounts for such banks.

# 2. Authorisation

## 2.1 Licences and Application Process

### Banking Licences

The Banking Act defines banking as the business of conducting both acceptance of deposits (including installment savings) and lending of funds (including discounting of bills and notes), or providing money transfer services. Any person wishing to engage in banking must obtain a licence under the Banking Act.

If a person wishes only to conduct the lending of funds and not the acceptance of deposits, a registration of money lending business under the Money Lending Business Act would suffice. Lending of funds requires a banking licence only when it is conducted together with the acceptance of deposits.

If a person wishes to only provide money transfer services not exceeding JPY1 million per transfer, a registration of money transfer services under the Payment Services Act would suffice under the current regulatory framework. It should be noted, however, that the current regulatory framework for money transfer services is soon to be changed, as explained in **10. Horizon Scanning**.

### Restrictions on Licensed Banks' Activities

The Banking Act provides for restrictions on the business scope of licensed banks. In particular, banks are not allowed to conduct any business other than banking, business incidental to banking, and certain business specifically permitted under the Banking Act or other laws. The Banking Act also provides for restrictions on the business scope of subsidiaries of licensed banks, although the restrictions applicable to banks' subsidiaries are not as strict as those applicable to banks themselves.

### Requirements for a Banking Licence

#### *Criteria for examination*

The Banking Act requires the regulator to examine whether an applicant for a banking licence satisfies the following criteria:

- "the applicant has a sufficient financial basis to perform banking services soundly and efficiently, and has good prospects in relation to income and expenditure in connection with those services"; and
- "in light of such points as its personnel structure, the applicant has the knowledge and experience to perform banking services appropriately, fairly, and efficiently, and has sufficient social credibility" (Article 4, Paragraph 2 of the Banking Act).

In addition, the regulator is authorised to impose such conditions on a banking licence as it deems necessary in light of the above criteria.

#### *Statutory requirements under the Banking Act*

A bank must be a stock company incorporated under the Companies Act of Japan and must have (i) a board of directors, (ii) a board of company auditors, audit and supervisory committee or nominating committee, etc, and (iii) a financial auditor. The Banking Act stipulates fit and proper principles requiring certain directors and officers of a bank to have certain knowledge and experience and to have sufficient social credibility. The stated capital of a bank must be no less than JPY2 billion.

If an applicant for a banking licence is a foreign bank, it does not need to be a stock company incorporated under the Companies Act of Japan, but it is required to establish a branch in Japan. The fit and proper principles explained above will apply to the representative in Japan of such foreign bank. A foreign bank branch is required to keep assets corresponding to its stated capital within Japan in an amount of no less than JPY2 billion.

### Application Process

The application process usually consists of the following steps with the FSA: (i) preliminary consultation, and (ii) formal application. In step (i), the applicant consults with the FSA and provides such information as is informally requested by the FSA for its preliminary examination. After completing this informal communication with the FSA, the applicant proceeds to step (ii) and submits application documents together with supporting materials to the FSA.

The Banking Act provides for a standard processing period for step (ii). In particular, the regulator must endeavour to process the application within one month from receiving such application. On the other hand, there is no standard processing period for step (i), as it is not a formal process under the Banking Act. The length of time required for step (i) is highly dependent on the circumstances surrounding individual applicants.

An applicant for a banking licence must pay JPY150,000 as a registration and licence tax for each application. This is the only statutory cost incurred in obtaining a banking licence. In practice, it is usual for an applicant to retain advisers to assist in the application process, and for the applicant to incur fees in relation to such advisers.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

### Notification of Large Volume Holding

A person who acquires more than 5% of the total voting rights in a bank must submit a notification to the regulator as required under the Banking Act. If the notified percentage of the voting rights increases or decreases by 1% or more, or if there is a change in the information stated in the notification, such person must submit a report on such change to the regulator.

### Bank Major Shareholder

A person must obtain prior approval from the regulator to acquire 20% (or, as the case may be, 15%) or more of the total voting rights in a bank. Once approved, such person is called a "Bank Major Shareholder" under the Banking Act and will be subject to the supervision of the regulator. In particular, if the holding ratio of a Bank Major Shareholder exceeds 50%, the regulator has authority to order the Bank Major Shareholder to submit an improvement plan to ensure sound management of the bank when necessary.

### Bank Holding Company

A Bank Holding Company is defined as a holding company that has a bank as its subsidiary. A subsidiary is defined as a company the majority of whose voting rights (ie, more than 50%) are held by another company. A person must obtain prior approval from the regulator to become a Bank Holding Company.

If a person wishes to acquire more than 50% of the total voting rights in a bank, there is an issue of whether such person must obtain approval as a Bank Holding Company or a Bank Major Shareholder. Approval as a Bank Holding Company will be required only if such person falls under the definition of a holding company. A holding company is defined as a company the majority of whose assets (ie, more than 50%) are comprised of shares in its subsidiaries in Japan.

A Bank Holding Company is subject to broader and stricter regulations than those applicable to a Bank Major Shareholder. The regulations applicable to a Bank Holding Company include:

- restrictions on the scope of business that a Bank Holding Company is permitted to conduct;
- restrictions on the scope of subsidiaries that a Bank Holding Company is permitted to own;
- governance requirements;
- capital adequacy requirements;
- accounting (including disclosure requirements); and
- supervision of the regulator (including authority to order a Bank Holding Company to submit an improvement plan to ensure sound management of the bank when necessary).

#### Foreign Shareholdings

There is no restriction on foreign shareholdings under the Banking Act. The above regulations on shareholdings in a bank (ie, notification of large volume holding, Bank Major Shareholder regulations, Bank Holding Company regulations) apply regardless of whether the shareholder is a domestic or foreign person. It should be noted, however, that the acquisition of a Japanese entity by a foreign investor may be subject to notification or other requirements under the Foreign Exchange and Foreign Trade Act.

## 4. Supervision

### 4.1 Corporate Governance Requirements

Under the Banking Act (Article 4-2), a bank must be a stock company (*kabushiki-kaisha*) as set forth in the Companies Act, with the following organs:

- a board of directors;
- a board of company auditors, a supervisory committee or a nominating committee, etc, as defined in Article 2, paragraph (12) of the Companies Act; and
- a financial auditor.

A foreign bank that has a branch office in Japan is not subject to this organisational requirement (Article 47, Paragraph 2 of the Banking Act).

In addition, VI-1 of the "Comprehensive Guidelines for Supervision of Major Banks, etc" issued by the FSA lists supervisory viewpoints to which the FSA would pay attention with respect to the corporate governance of a bank.

For example:

- as a general principle, corporate governance is important for the stability of the financial system, and for the sustainability and appropriate management of a bank;
- a listed bank or a listed bank holding company should comply with "Japan's Corporate Governance Code – Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term", issued by the Tokyo Stock Exchange, Inc;
- a listed bank or a listed bank holding company should appoint at least two independent outside directors who would contribute to sustainable corporate growth and the increase of corporate value; and
- a listed bank or a listed bank holding company should disclose its policy with respect to cross-shareholdings.

### 4.2 Registration and Oversight of Senior Management

#### Process of Election of Directors and Executive Officers

As a general rule not limited to a bank, a director of a stock company (*kabushiki-kaisha*) under the Companies Act is elected by a resolution at a shareholders' meeting (Article 329 of the Companies Act), while an executive officer of a company with a nominating committee, etc (as defined in Article 2, Paragraph (12) of the Companies Act) is elected by a resolution at a meeting of the board of directors. Neither the Companies Act nor the Banking Act stipulate a regulatory approval requirement in respect of the appointment of a director or an executive officer.

#### Restriction on the Concurrent Holding of Other Positions with Respect to Directors and Executive Officers

A director (or an executive officer, if the bank is a company with a nominating committee, etc, as defined in Article 2, Paragraph (12) of the Companies Act) that is engaged in the day-to-day business operations of a bank must not engage in the day-to-day business operations of any other company without the authorisation of the Prime Minister (Article 7, Paragraph 1 of the Banking Act).

When an application is filed for such authorisation, the Prime Minister must not grant that authorisation unless the Prime Minister finds that the particulars to which the application pertains are unlikely to interfere with the sound and appropriate management of bank services (Article 7, Paragraph 2 of the Banking Act).

A foreign bank that has a branch office in Japan is subject to these rules (Article 47, Paragraph 2 of the Banking Act).

### Eligibility for Director or Executive Officer

A director engaged in the day-to-day business of a bank (or an executive officer engaged in the day-to-day business of a bank, if the bank is a company with nominating committee, etc, as defined in Article 2, Paragraph (12) of the Companies Act) must have the knowledge and experience to be able to carry out the business management of a bank appropriately, fairly and efficiently (Article 7-2, Paragraph 1 of the Banking Act).

In addition, no person subject to an order of commencement of bankruptcy proceedings who has not been discharged from bankruptcy and no person who is treated as the equivalent of the foregoing under foreign laws and regulations may become a director or an executive officer of a bank (Article 7-2, Paragraph 2 of the Banking Act).

A foreign bank that has a branch office in Japan is subject to these rules (Article 47, Paragraph 2 of the Banking Act).

### Notification

A bank must file a prior notification with the Prime Minister when a director representing the bank or a director engaging in ordinary business of the bank is appointed or resigns (Article 53, Paragraph 1, Item 8 of the Banking Act and Article 35, Paragraph 1, Item 3 of the Regulation for Enforcement of the Banking Act).

A foreign bank that has a branch office in Japan is subject to these rules (Article 47, Paragraph 2 of the Banking Act).

### Duties of Directors and Executive Officers

As a general rule under the Companies Act, directors and executive officers owe a duty of care and a duty of loyalty to the company (Article 330, Article 355 and Article 402, Paragraph 2 of the Companies Act, and Article 644 of the Civil Code).

A bank must not extend credit to its directors or executive officers under terms and conditions that are disadvantageous to the bank compared to the ordinary terms and conditions under which the bank extends credit (Article 14, Paragraph 1 of the Banking Act).

## 4.3 Remuneration Requirements

The Banking Act provides no rule with respect to remuneration paid by a bank to its directors, executive officers or employees.

1-2-3-5 of the "Comprehensive Guidelines for Supervision of Major Banks, etc" issued by the FSA lists supervisory viewpoints to which the FSA would pay attention with respect to remuneration paid by a bank to its directors, executive officers or employees, as follows:

- a bank's remuneration system is not appropriate if it drives excessive risk-taking by a director, an executive officer or an employee of the bank;
- the remuneration committee of a bank should supervise the bank's remuneration system so that such remuneration system is appropriately established and managed;
- the remuneration committee of a bank should check whether or not the amount of remuneration would have a material effect on the bank's core capital;
- the remuneration committee of a bank should communicate with the risk monitoring department of the bank;
- the remuneration committee of a bank should check whether or not its remuneration system causes excessive short-termism or becomes excessively performance-based; and
- the remuneration of staff in the risk monitoring department and compliance department should be determined independently from other business departments and based on the importance of their roles.

In cases where the FSA thinks that a bank's remuneration system is problematic as a result of regular off-site monitoring or inspection, it shall require the bank to submit a report under Article 24, Paragraph 1 of the Banking Act as necessary. If a serious problem is recognised, the FSA shall take administrative action, such as issuing an order for business improvement under Article 26 of the Banking Act.

# 5. AML/KYC

## 5.1 AML and CTF Requirements

### Overview

The principal laws and regulations governing anti-money laundering and counter-terrorist financing are the Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007) and the subordinate regulations enacted thereunder, including the Order for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds (Cabinet Order No. 20 of 2008) and the Regulation for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds (Ministry of Finance Order No. 1 of 2008).

In addition, the FSA issues "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism", which clarify the required actions and expected actions to be implemented by financial institutions, such as banks, and how the FSA shall conduct monitoring going forward.

The Act on Prevention of Transfer of Criminal Proceeds provides for preventative measures in combating money laundering and terrorist financing, by imposing obligations such as customer due diligence, record keeping and the reporting of suspicious transactions on "specified business operators". A bank is one such "specified business operator".

#### Customer Due Diligence (Article 4 of the Act on Prevention of Transfer of Criminal Proceeds)

When a bank enters into a transaction ("Specified Transaction") listed in Article 7 of the Order for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds (Cabinet Order No. 20 of 2008) with its customers who are natural persons, it is required to verify their identification data (name, address and date of birth), the purpose and intended nature of the transaction, and the customer's occupation, by checking their identification documents, such as a driver's licence.

When a bank enters into a Specified Transaction with its customers who are legal persons, such as corporations, it must verify their identification data (the name and location of the head office or main office), the purpose and intended nature of the transaction, the type of business, and the beneficial owner(s).

When a bank enters into a Specified Transaction with an agent or a representative of a customer, it must verify the identification data in respect of such agent or representative.

When a bank enters into a transaction that has a high risk of being related to money laundering or terrorist financing, such as a transaction where the bank suspects its counterparty is disguising its identity, the bank is required to verify items related to verification at the time of the transaction, using a more robust method.

#### Record-Keeping

A bank is required to prepare and preserve verification records collected at the time of the transaction, as well as measures taken for verification of the customer at the time of the transaction, for seven years from the day when the transaction is made or when an agreement related to the transaction is terminated, depending on the type of the transaction (Article 6 of the Act on Prevention of Transfer of Criminal Proceeds).

In addition, a bank is required to prepare records of the date and contents of transactions, and to keep these records for seven years from the date of such transaction (Article 7 of the Act on Prevention of Transfer of Criminal Proceeds).

#### Reporting Suspicious Transactions (Article 8 of the Act on Prevention of Transfer of Criminal Proceeds)

A bank is required to file a suspicious transaction report with the competent administrative authority in cases where assets received through a transaction are suspected to be criminal proceeds, or where the customer is suspected to be engaged in money laundering.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

#### Scheme Administration and Supervision

The Deposit Insurance Corporation (DIC) is a special corporation organised under the Deposit Insurance Act of Japan (Act No. 34 of 1971 – DIA) and administers the deposit insurance system. The Prime Minister generally supervises DIC's operation of the system, and also determines or approves specific administrative procedures in respect of failed financial institutions or successors thereto. The Prime Minister delegates most of his/her authorities under DIA to the FSA.

#### Scope of Protection

The deposit insurance system protects depositors by either providing financial assistance to a successor financial institution and thereby indirectly making insurance proceeds available to depositors ("Financial Assistance Method"), or directly paying insurance proceeds to depositors of a failed financial institution ("Insurance Pay-out Method"). The Financial Assistance Method is more cost-effective and causes less confusion compared to the Insurance Pay-out Method. DIC has resorted to the Financial Assistance Method in dealing with almost all failed financial institutions.

Either way, only those with insured deposits with insured financial institutions are protected under the system up to the statutory limit (if applicable).

*Insured financial institutions*

Banks and other deposit-taking financial institutions licensed in Japan are insured under the deposit insurance system, with some exceptions.

One of the exceptions is foreign branches of licensed financial institutions. Another exception is Japanese branches of foreign banks: under the Banking Act, instead of establishing a licensed bank in Japan, foreign banks may obtain a licence and conduct banking business through their branches in Japan; however, such licensed branches are not covered by the deposit insurance system. Agricultural/fishery co-operatives and related financial institutions are insured not under the deposit insurance system but under a separate "savings" insurance system.

Governmental financial institutions are not covered by these insurance systems. Insurance and securities firms receive premiums, margins and other types of funds from their customers, the economic nature of which funds is similar to deposits; however, these firms are not deposit-taking financial institutions and are thus not insured under the aforementioned insurance systems. Nonetheless, part of such customer funds are covered by separate customer protection systems. As described in **9.1 Legal and Regulatory Framework**, these firms are also subject to the new resolution regime established in line with the FSB Key Attributes.

***Insured deposits***

Deposits for payment and settlement ("Settlement Deposits") with the insured financial institutions are fully covered by the deposit insurance system (ie, without being restricted by the statutory limit applicable to General Deposits – defined below). To qualify as Settlement Deposits, the deposits must bear no interest, be redeemable on demand, and be used for payment and settlement.

Deposits other than Settlement Deposits ("General Deposits") are also protected but only within the statutory limit of JPY10 million in principal plus interest thereon, per depositor, per insured financial institution.

Certain deposits are disqualified as Settlement Deposits and General Deposits. Among others, foreign currency deposits are disqualified, given the volatility of exchange rates. Negotiable certificates of deposit, bearer deposits and deposits under an alias or fictitious name are also disqualified due to difficulties in identifying the true depositors. Other examples of disqualified deposits are deposits from insured financial institutions and deposits in respect of Japan offshore market accounts.

In addition to Settlement Deposits and General Deposits, when an insured financial institution is processing a fund remittance or certain other settlement transactions requested by a customer, obligations in relation to the customer are also fully protected. If the settlement transactions are denominated in a foreign currency or requested by other insured financial institutions, the obligations thereunder are disqualified and not insured.

Uninsured deposits or obligations may be paid as tenders or dividends through bankruptcy/rehabilitation proceedings, depending on the status of assets of the relevant failed financial institution (see **9.1 Legal and Regulatory Framework**).

### Funding of Deposit Insurance System

DIC is funded mainly by the receipt of insurance premiums from insured financial institutions and capital contributions from the government, BOJ and certain financial institutions. DIC also raises funds by issuing bonds or by borrowing from financial institutions.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

### Duty of Confidentiality

Neither the Banking Act nor any other act contains any provision in respect of bank secrecy requirements. In Japan, banks' duty of confidentiality has been established and developed by the case law of the Supreme Court, which has held that a financial institution owes its customers a duty of confidentiality, which is based on business practices or an agreement between the financial institution and its customer; the financial institution may not disclose information on transactions between itself and its customer, information on a customer's credit risk, or any other customer information to another person, unless for good reason.

Based on such established case law, Article 12-2, Paragraph 2 of the Banking Act provides that a bank must appropriately handle customer information it acquires in the course of its services. In addition, III-3-3-3 of the "Comprehensive Guidelines for Supervision of Major Banks, etc" issued by the FSA states that the FSA would pay attention to whether or not a bank has established an appropriate information management system.

It is generally understood that a bank may disclose customer information upon reasonable grounds, such as when the customer explicitly or implicitly consents to such disclosure, or when the bank is legally required to disclose customer information. It should be noted that a bank is not always allowed to transfer its customer information to its affiliates under such duty of confidentiality. Because the bank's duty of confidentiality has been established and developed by the case law, it is sometimes unclear whether or not a bank may disclose certain customer information without breaching its duty of confidentiality, including the case where a bank shares certain customer information with its affiliates.

When a bank breaches such duty of confidentiality, it would be liable for damage to the customer arising from such breach. In addition, if, as a result of regular offsite monitoring or inspection, the FSA thinks that a bank's information management system is problematic, it shall require the bank to submit a report under Article 24, Paragraph 1 of the Banking Act as necessary. If a serious problem is recognised, the FSA shall take administrative action, such as issuing an order for business improvement under Article 26 of the Banking Act.

### Personal Data Protection

If a bank's customer is a natural person, the customer information would fall under "personal data" under the Act on the Protection of Personal Information (Act No 57 of 2003), and the disclosure of such customer information would be subject to personal data protection regulations, including the Act on the Protection of Personal Information. A bank is required to prevent the leakage, loss or damage of customer information that falls under personal data, and to conform to the requirements regarding the scope and purpose of any shared use.

#### Firewall Regulations

A bank is subject to so-called firewall regulations, the original aim of which is to prevent the bank from abusing its dominant bargaining position. These firewall regulations prohibit a bank from sharing its non-public customer information with its affiliates without the customer's prior approval, provided, however, that (i) sharing of non-public customer information for internal management purposes is permitted and (ii) sharing of non-public corporate customer information is permitted if the relevant bank provides the corporate customer with an opt-out opportunity in advance.

## 8. Prudential Regime

### 8.1 Capital, Liquidity and Related Risk Control Requirements

#### Adherence to Basel III Standards for Internationally Active Banks

Under the Banking Act, banks must meet capital, liquidity and related risk control requirements. Banks are also required to avoid having large exposures to single counterparties. To enable group-level risk management, the Banking Act and regulations thereunder cover not only banks but also bank holding companies.

This risk control framework aims to be consistent with the Basel III standards set by the Basel Committee on Banking Supervision (BCBS), to the extent applied to internationally active banks (ie, banks having a branch or a banking subsidiary overseas).

Reviews of this risk control framework under the BCBS's Regulatory Consistency Assessment Programme (RCAP) have assessed the framework as being "compliant" with the requirements of the Basel III standards that relate to risk-based capital, liquidity (LCR) and G-SIBs and D-SIBs.

No results of assessments of other requirements, such as the stable funding ratio (NSFR) and large exposure framework, are currently available; however, the FSA has continuously amended the relevant regulations with a view to adhering to the updated Basel III standards in these areas.

The FSA has announced that the national implementation of the finalised Basel III standards has been postponed until the fiscal year ending March 2023, in light of the related announcement of the Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the BCBS.

#### Risk Control Framework for Domestic Banks

Domestic banks are also subject to the aforementioned risk control framework, but under less strict requirements compared to internationally active banks. For instance, domestic banks are only required to meet a minimum capital ratio (the ratio of "core" capital amount to risk asset amount) of 4%; on the other hand, several types of threshold are set as the minimum capital ratio of internationally active banks (eg, 8% for "Tier 1" plus "Tier 2" equity, 6% for "Tier 1" equity and 4.5% for "Common Equity Tier 1"). Domestic banks are not subject to capital buffer requirements and certain other risk management rules.

#### Risk Management and Correction Measures

Under the aforementioned risk control framework, banks are primarily responsible for managing their risks. The FSA continually monitors the risk status of banks, and takes early correction measures if a bank fails to meet the minimum capital requirement, which include the order to file an improvement plan, the order to enhance capital and the order to suspend or abolish the whole or part of a business. As a preventative measure, the FSA may also issue an early warning to a bank that satisfies the minimum capital requirement but in relation to which bank there is still a risk-related concern requiring improvement. With respect to internationally active banks, a failure to meet capital buffer requirements leads to an order from the FSA to restrict capital distribution.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

#### Administrative Procedures

##### *Ordinary resolution procedures*

The FSA appoints DIC as a "financial administrator" of a financial institution that has excessive liabilities or is at risk of suspending repayment of deposits, if its operations are extremely inappropriate or if its dissolution seriously hinders smooth fund flows and the convenience of its customers in relevant regions or sectors.

Once appointed as financial administrator, DIC is authorised to control the operations and manage the assets of the failed financial institution. With such authority, DIC is expected to promptly transfer such institution's business, including deposits, to a successor financial institution so that DIC may be able to provide financial assistance to such successor financial institution for the protection of depositors under the Financial Assistance Method. The amount of such assistance is limited to the amount of the insurance proceeds. If DIC fails to identify a successor financial institution promptly, the FSA directs DIC to establish a bridge bank to which the business of the failed financial institution is transferred for the time being. DIC attempts to re-transfer the business from the bridge bank once a successor financial institution is identified.

Only financial institutions insured under the deposit insurance system (see **6.1 Depositor Protection Regime**) are subject to these resolution procedures.

***Resolution procedures in the face of systemic risk***

In the face of an extremely serious threat to the maintenance of the credit stability of Japan or relevant regions (systemic risk), the Prime Minister convenes the Financial System Management Council and determines the necessity of financial assistance in relation to a failed or insolvent financial institution (the so-called "Item 2 Measure"). Unlike the Financial Assistance Method under the ordinary resolution procedures, this Item 2 Measure enables financial assistance exceeding insurance proceeds, given the necessity to address the emerging systemic risk. Following the determination by the Prime Minister, the FSA appoints DIC as financial administrator, and DIC provides financial assistance exceeding the insurance proceeds.

If the financial institution is insolvent and has failed, and if the systemic risk is too serious to be avoided by the Item 2 Measure, the Prime Minister determines the necessity of the acquisition of shares in such financial institution (so-called special crisis management or Item 3 Measure). Following the determination by the Prime Minister, the FSA directs DIC to acquire shares in the failed and insolvent financial institution, and thereby substantially nationalises such institution.

Financial institutions that are not eligible for these measures (ie, those which are neither insolvent nor have failed) may still receive a capital injection from DIC to recover their capital adequacy ratio in line with the direction of the FSA (so-called Item 1 Measure).

Only financial institutions insured under the deposit insurance system (see **6.1 Depositor Protection Regime**) are subject to these resolution procedures.

***A new regime in line with FSB Key Attributes***

The FSB Key Attributes were implemented by amending DIA in 2013 and thereby granting the Prime Minister and DIC authority to resolve financial institutions.

Under the amended DIA, the Prime Minister may determine that, following the convening of the Financial System Management Council, it is necessary to take recovery or resolution measures for financial institutions where, without such measures, there is a risk of extreme disruption to the Japanese financial market or other financial systems.

It is noteworthy that not only insured financial institutions (ie, insured banks and other deposit-taking financial institutions; see **6.1 Depositor Protection Regime**) but also Japanese branches of foreign banks, licensed insurance and securities firms and holding companies thereof may be subject to this new regime. DIC plays an important role under this regime, including through the provision of financial assistance to successors of insolvent financial institutions with a view to ensuring the performance of important transactions in the financial market. DIC also provides liquidity even to solvent financial institutions as necessary.

This new regime is generally in line with the FSB Key Attributes, including the recovery planning, the temporary stay, contractual bail-in mechanism and ex post recovery of costs from the industry.

**Judicial Procedures**

The commencement of the aforementioned administrative procedures does not exclude the possibility of judicial procedures against a failed financial institution in relation to its bankruptcy/rehabilitation. Rather, to achieve the aim of each of these administrative procedures, it is essential to concurrently commence bankruptcy/rehabilitation proceedings and thereby prevent the deterioration of such failed institution's assets and enable it to perform its obligations (eg, with respect to uninsured deposits; see **6.1 Depositor Protection Regime**) to the extent permitted under such proceedings. Although DIA sets out certain provisions addressing the conflict between the administrative and judicial procedures, there are no insolvency preference rules applicable to deposits.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

**Amendment to ASFI and PSA**

On 5 June 2020, the Diet passed a bill to amend the Act on Sales, etc. of Financial Instruments (ASFI) and the Payment Services Act (PSA) for the purposes of introducing a new regulatory framework for the brokerage of financial products, and revising the current regulatory framework for payment and settlement. This amendment ("Amendment") was promulgated on 12 June 2020 and will enter into force within 18 months of the date of promulgation.

**New framework for brokerage of financial products**

*Outline*

The Amendment will introduce a new regulatory framework entitled "Financial Service Brokerage" in order to facilitate a one-stop service by brokers to offer financial products throughout all sectors of banking, insurance and securities. In particular, this is expected to encourage online service providers or platforms to add financial products to the services they offer to users. From the viewpoint of the banking sector, this would be regarded as the creation of a new sales channel. Banks would need to consider whether and how to collaborate with this new sales channel.

The new regulatory framework will have two unique characteristics:

- cross-sectoral licensing across all sectors of banking, insurance and securities; and
- non-adoption of the existing "affiliation framework".

*Cross-sectoral licensing*

Under the current legislation, brokers wishing to provide a one-stop service must obtain the necessary licence under each relevant statute for each sector (eg, the Banking Act; the Insurance Business Act; the Financial Instruments and Exchange Act).

The Amendment will revise the ASFI (and rename it the "Act on Provision of Financial Services") to introduce the new regulatory framework of "Financial Service Brokerage", which will allow brokers to offer financial products in any or all sectors across banking, insurance and securities with only one licence (registration) as a "Financial Service Broker". Having said that, the current regulatory framework for brokerage under each sectoral statute will also continue in parallel with the new regulatory framework to be introduced under the amended ASFI.

Under the amended ASFI, Financial Service Brokerage comprises four categories:

- Deposit Intermediary;
- Insurance Intermediary;
- Securities Intermediary; and
- Lending Business Loan Intermediary.

Registration as a Financial Service Broker will be required for each of these categories. In particular, applicants for registration as a Financial Service Broker will need to disclose in their application documents which of the four categories they wish to operate within. The regulator will then proceed to examine the applicants according to the categories indicated. Brokers that wish to change the categories under which they are registered will need to apply to the regulator again to become registered under the desired new categories.

*Non-adoption of the affiliation framework*

The current regulatory framework for brokers under each relevant statute generally adopts an "affiliation framework", under which brokers are affiliated with (or belong to) specific financial institutions (eg, banks, insurance companies, securities firms). In turn, the affiliated financial institutions are responsible for the supervision of the affiliated brokers and are liable for any damage caused to customers by the affiliated brokers.

The amended ASFI does not apply the same affiliation framework to Financial Service Brokers. Consequently, Financial Service Brokers will be able to offer the products of multiple financial institutions more easily than existing brokers, who would need to be affiliated with specific financial institutions under the affiliation framework.

On the other hand, as there will be no supervision over the conduct of Financial Service Brokers by affiliated financial institutions, the amended ASFI will impose the following restrictions on Financial Service Brokers in order to protect customers:

- Financial Service Brokers will not be permitted to act as an agent and will only be permitted to act as an intermediary;
- Financial Service Brokers will not be permitted to offer certain financial products that require a highly technical explanation; and
- Financial Service Brokers will not be permitted to receive deposits of money or other property from customers.

Furthermore, no affiliated financial institutions will owe any liability for damage caused by Financial Service Brokers to customers. In other words, customers will not be able to claim damage against affiliated financial institutions and will only be able to make claims against the Financial Service Brokers themselves. Therefore, the amended ASFI will generally require Financial Service Brokers to set aside a security deposit of a certain amount for the purpose of ensuring the financial ability of Financial Service Brokers to pay compensation for damage to customers if necessary.

***Revision to framework for payment and settlement***

Under Japanese law, money transfer services are regulated by either the Banking Act or the PSA.

Historically, only banks licensed under the Banking Act were allowed to provide money transfer services. In 2009, the PSA was enacted to allow registered service providers to provide money transfer services, subject to an upper limit of JPY1 million per transfer.

The Amendment will make several revisions to the current regulatory framework for payment and settlement under the PSA, with the most notable change being an amendment to the aforementioned upper limit imposed on money transfer service providers registered under the PSA. This would have an impact on the banking sector as it is expected to promote competition between money transfer service providers registered under the PSA and banks licensed under the Banking Act.

*New type of services for a large amount transfer*

The Amendment will introduce a new type of money transfer service, under which it will be permitted to transfer amounts exceeding JPY1 million but which will be subject to stricter regulations (Type I Money Transfer Services).

To conduct Type I Money Transfer Services, a banking licence under the Banking Act will not be necessary, but approval will be required in addition to registration under the PSA. The PSA will also impose the following stringent restrictions regarding the retention of money on the approved providers of Type I Money Transfer Services:

- a prohibition on taking receipts of money from customers if the transaction details (eg, the amount, date and time of remittance) are unconfirmed; and
- a prohibition on taking receipts of money from customers for a period longer than necessary for the remittance.

*New type of services for a small amount transfer*

The Amendment will also introduce a type of money transfer service under which it will only be permitted to transfer amounts below a certain limit – yet to be determined by a separate Cabinet Order – and which will be subject to less strict regulations (Type III Money Transfer Services).

Money transfer service providers are generally required under the PSA to protect in-transit money by way of statutory deposit, bank guarantee or trust agreement. However, the Amendment will allow providers of Type III Money Transfer Services to protect in-transit money by way of simple deposit in a segregated bank account, as an alternative to statutory deposit, bank guarantee or trust agreement. In relation to this method of simple bank deposit, external auditing of such bank account will be required.

*Amendment to existing type of services*

Lastly, the existing money transfer services regulated under the current PSA will be categorised as Type II Money Transfer Services under the amended PSA. Regulations applicable to Type II Money Transfer Services will basically remain unchanged except for certain revisions, including the introduction of a general requirement to take measures to prevent the retention of money that is not related to a remittance (which could be viewed as the acceptance of deposits without a banking licence).

### Special Provisions of the Antimonopoly Act

On 20 May 2020, the Diet passed a bill to create special provisions of the Antimonopoly Act to facilitate mergers among regional banks to ensure the sustainability of essential services for local residents rendered by the regional banks in municipalities. The new law will enter into force on 27 November 2020.

By way of background, services rendered by regional banks in the respective municipalities are perceived as "essential services" that are the basis for the lives and economic activities of local residents, being difficult to be replaced by other operators/providers. However, the existing regional banks are facing difficulties in providing such essential services in a sustainable manner, for reasons such as declining population.

To ensure the sustainability of such essential services, the new law will exempt from the relevant provisions of the Antimonopoly Act certain cases of business enhancement through mergers among regional banks in municipalities that may conflict with the Antimonopoly Act. This would have an impact on the banking sector as it is expected to motivate regional banks to consider merging as one of their strategies for future survival.

### Discussion on Amendments to Banking Act

On 30 September 2020, the FSA announced that it had started discussions on new amendments to the Banking Act among the members of the "Working Group on the Japanese Banking System" of the Financial System Council.

Amendments to be discussed will include:

- relaxation of the restrictions on the scope of business by banks;
- relaxation of the restrictions on the scope of business by banks' subsidiaries;
- amendment to the regulations on Bank Major Shareholders and Bank Holding Companies; and
- relaxation of firewall requirements between banks and securities firms, such as the restrictions on the sharing of customer data.

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**Nagashima Ohno & Tsunematsu** is the first integrated full-service law firm in Japan and one of the foremost providers of international and commercial legal services based in Tokyo. The firm's overseas network includes offices in New York, Singapore, Bangkok, Ho Chi Minh City, Hanoi and Shanghai, associated local law firms in Jakarta and Beijing where the lawyers are on-site, and collaborative relationships with prominent local law firms throughout Asia and other regions. In representing leading domestic and international clients, the firm has successfully structured and negotiated many of the largest and most significant corporate, finance and real estate transactions related to Japan. It has extensive corporate and litigation capabilities spanning key commercial areas such as antitrust, intellectual property, labour and taxation, and is known for ground-breaking domestic and cross-border risk management/corporate governance cases and large-scale corporate reorganisations. The approximately 500 lawyers of the firm, including more than 30 experienced foreign attorneys from various jurisdictions, work together in customised teams to provide clients with the expertise and experience specifically required for each matter.

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# Trends and Developments

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## Establishment of Financial Services Intermediary Business

### *Overview*

On 6 March 2020, the Financial Services Agency (FSA) submitted a bill (Bill or Act) to the Diet for the revision of the Act on Sales, etc. of Financial Instruments (ASFI) and the Payment Services Act (Bill for Revising the Act on Sales, etc. of Financial Instruments etc. for Convenience and Protection of Financial Service Users). The Bill is chiefly focused on (i) the establishment of a financial services intermediary business that is capable of intermediating cross-sectoral financial services of banking, securities and insurance under a single licence, and (ii) the classification of funds transfer services into three categories according to certain maximum limits on remittance amounts. We are focusing on item (i) below.

The Bill was enacted on 5 June 2020 and promulgated on 12 June 2020, and the Act will come into force no later than one year and six months after 12 June 2020; the relevant date will be specified in an upcoming Cabinet Order.

In accordance with the Act, the name of the ASFI will be changed to the Act on Provision of Financial Services upon the enforcement of the revision.

### *Circumstances leading to the revision of the ASFI*

In the "Report on the development of regulations regarding payment and settlement and cross-sectional financial services intermediaries – basic concept" published on 26 July 2019 by the Study Group on the Financial System of the Financial System Council ("Basic Concept"), it was pointed out that, under the current regulatory system, a business operator faces the following difficulties in order to intermediate the financial services provided by multiple financial institutions across multiple business types (ie, banking, securities and insurance):

- under current regulations, financial services are divided into "functions", such as those undertaken by (i) bank agents and electronic payment service providers under the Banking Act, (ii) financial instruments intermediary service providers under the Financial Instruments and Exchange Act, and (iii) insurance agents and insurance brokers under the Insurance Business Act. Therefore, a business operator handling products and services across multiple "sectors" is required to apply for multiple licences; and
- under current regulations, a business intending to act as an agent or the intermediary for multiple financial institutions (ie, principals) in handling the products and services provided by such financial institutions is required to bear the significant burden of responding to the instructions of each of these principals.

Accordingly, the following recommendations were made in the Basic Concept:

- to enable a business operator to engage in intermediary services in respect of products and services across multiple business types without having to apply for multiple licences for each business type; and
- to ensure the protection of users through, for example, limiting the products and services that business operators are permitted to handle, a prohibition against the receipt of funds deposits, and the application of certain financial restrictions, without the requirement for a licence holder to restrict itself to one financial institution as its principal.

In light of the above and following internal discussions, the Working Group on Regulations for Payment Services Providers and One-Stop Financial Services Intermediaries issued a report on 20 December 2019 ("WG Report") proposing the establishment of the following:

- a flexible and balanced regulatory system to provide a more convenient, secure and safe payment service that meets users' needs in the age of cashless payments; and
- an industry suitable for financial services intermediaries who are seeking to provide a convenient one-stop service through which users can gain access to various financial services.

In light of this proposal, the Bill was passed to enable the establishment of financial services intermediary businesses without the requirement for a licence holder to restrict itself to one financial institution as its principal.

### *Scope of business*

The term "financial services intermediary business" is defined as the business of engaging in "intermediary services for deposits, etc", "insurance intermediary services", "securities intermediary services" or "money lending businesses and lending intermediary services" (Article 11 of the ASFI, as revised under the Bill – "the ASFI Revisions"). As the WG Report stated that the activity of "acting as agent" would be excluded from the scope of the intermediary activities of a new intermediary business, no reference to "acting as agent" is found in the definition of "financial services intermediary business" in Article 11 of the ASFI Revisions.

Article 11 of the ASFI Revisions is generally understood as defining the scope of financial services-related intermediary services that may be provided by anyone other than those already licensed or registered to engage in such services, so as to prevent the application of the new regulations under the ASFI Revisions to existing intermediary service providers.

*Intermediary services for deposits, etc*

The term "intermediary services for deposits, etc" encompasses intermediation for the conclusion of contracts regarding the acceptance of deposits, etc, on behalf of banks, intermediation for the conclusion of contracts regarding the provision of loans or bill discounting (excluding acts conducted by a money lender in favour of its customer), and intermediation for the conclusion of contracts regarding funds transfers on behalf of banks, etc.

*Insurance intermediary services*

The term "insurance intermediary services" encompasses intermediation for the conclusion of insurance contracts.

*Securities intermediary services*

The term "securities intermediary services" encompasses the following:

- intermediation for the purchase and sale of securities (excluding acts relating to any Proprietary Trading System);
- intermediation for:
  (a) the purchase and sale of securities in the financial instruments exchange market or foreign financial instruments market; or
  (b) the consignment of market derivatives transactions or foreign market derivative transactions;
- the handling of public offerings or secondary distribution of securities or the handling of private placements of securities or offers to sell, etc, to professional investors on behalf of financial instruments business operators engaged in Type-I financial instruments business and registered financial institutions; and
- intermediation for the conclusion of investment advisory contracts or discretionary investment contracts.

*Money lending businesses and lending intermediary services*

The term "money lending businesses and lending intermediary services" encompasses intermediation for the conclusion of contracts regarding the provision of loans or bill discounting (excluding acts conducted in the course of a business regulated by another law and the items listed in Article 2, Paragraph 1 of the Money Lending Business Act (other than item 2)).

***Exclusion of services requiring highly specialised explanations to customers***

The ASFI Revisions exclude the handling of financial instruments that are specified by Cabinet Order as requiring highly specialised explanations to customers from the scope of financial services intermediary business (Article 11, Paragraphs 2-4 of the ASFI Revisions). According to the Working Group's explanatory materials, it is assumed that the scope of the products a financial services intermediary business operator will be permitted and prohibited to handle will be as follows.

*Intermediary services for deposits, etc*

The ASFI Revisions permit intermediation in respect of savings deposits, fixed/cumulative deposits, housing loans and funds transfers under intermediary services for deposits, etc.

However, intermediation of structured deposits, foreign currency deposits and currency option incorporation-type deposits is expected to be prohibited under intermediary services for deposits, etc.

*Insurance intermediary services*

The ASFI Revisions permit intermediation of whole life/term insurance, individual pension insurance, medical life insurance, nursing care insurance, accident insurance, travel insurance, golf insurance and pet insurance under insurance intermediary services. It should be noted in this connection that a cap on the amount of insurance is likely to be introduced for insurance products handled by the financial services intermediaries.

However, intermediation of the following under insurance intermediary services will be prohibited: variable insurance, pensions insurance, pensions the cancellation refund of which is variable, and foreign currency insurance and pensions.

*Securities intermediary services*

The ASFI Revisions permit intermediation of government and local government bonds, listed shares and listed corporate bond certificates, and investment trusts and ETFs under securities intermediary services.

However, intermediation of unlisted shares and unlisted corporate bond certificates, derivative transactions and margin trading will be prohibited under securities intermediary services.

***Adoption of registration system***

*Registration system*

Article 12 of the ASFI Revisions stipulates that a financial services intermediary business must be operated by a person registered with the Prime Minister. In addition, a financial services intermediary business operator must file a registration of change if it intends to change the type of its financial services intermediary business (Article 16, Paragraph 1 and Article 13, Paragraph 1, Item 4 of the ASFI Revisions).

Certain parts of the written application and supporting documents required to be submitted for a registration apply regardless of the type of financial services intermediary business involved. Other parts, however, are specific to the type of financial services intermediary business an applicant is applying to engage in (Article 13, Paragraphs 1 and 2 of the ASFI Revisions).

*Grounds for rejection of registration*

The ASFI Revisions set forth the grounds on which an application for a registration of change may be rejected. Some of these grounds apply regardless of the type of financial services intermediary business involved, while others are specific to the type of financial services intermediary business an applicant is applying to engage in (Article 15 of the ASFI Revisions).

It should be noted that non-participation in a certified financial services intermediary business association does not constitute a ground for such rejection (see Article 15, Item 1(r) of the ASFI Revisions).

*Operation of both financial services intermediary businesses and electronic payment services by financial services intermediary business operator*

The ASFI Revisions provide that a financial services intermediary business operator engaging in financial services intermediary services using information and communication technology that satisfies certain requirements may engage in electronic payment services without undergoing registration as an electronic payment services provider under the Banking Act, provided that such business operator files a notification of the information required to be disclosed under Article 52-61-3, Paragraph 1 of the Banking Act with the Prime Minister (Article 18, Paragraphs 1 and 3 of the ASFI Revisions).

In such cases, the financial services intermediary business operator will be deemed to be an electronic payment service provider that is subject to the provisions of the Banking Act and other laws (Article 18, Paragraph 2 of the ASFI Revisions).

*Payment of security deposit*

The ASFI Revisions require financial services intermediary business operators to pay a security deposit of an amount specified by Cabinet Order, and only permits their conduct of financial services intermediary services after they have filed a notification of payment of a security deposit (Article 22, Paragraphs 1-3 and Paragraph 5 of the ASFI Revisions). However, a financial services intermediary business operator that has concluded a liability insurance contract pursuant to the provisions of the Cabinet Order may, with the Prime Minister's authorisation, withhold payment of part of the security deposit based on the amount of insurance proceeds payable under the contract, so long as the contract remains in effect (Article 23 of the ASFI Revisions). As stated above, the specific amount of such security deposit will be stipulated by Cabinet Order.

***Establishment of regulations on services***

The ASFI Revisions set forth certain common business conduct regulations (relating to, among others, the display of signs, the prohibition against name lending, the payment of security deposits, good faith obligations, obligations to provide information, operational management, the prohibition against receipt of funds deposits and obligations to conclude a contract with a designated dispute resolution organisation) applicable to all financial services intermediary business operators, as well as business conduct regulations that are specific to the operators engaging in certain types of financial services intermediary business.

***Establishment of provisions on accounting***

The ASFI Revisions require a financial services intermediary business operator to prepare books and business reports (Articles 33 and 34 of the ASFI Revisions).

***Establishment of provisions on supervision***

The ASFI Revisions contain provisions relating to the manner in which financial services intermediary business operators will be supervised. Specific provisions have been established, such as orders for the provision of reports and materials, on-site inspections, business improvement orders, and the rescission and cancellation of registrations (Articles 35-39 of the ASFI Revisions).

***Establishment of provisions on certified financial service intermediary business associations***

The ASFI Revisions contain provisions concerning certified financial services intermediary business associations serving as self-regulatory organisations overseeing financial services intermediary business operators (Articles 40-50 of the ASFI Revisions).

It should be noted, however, that financial services intermediary business operators are not obliged to join any certified financial services intermediary business association (Article 15, Item 1(r) of the ASFI Revisions).

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**Anderson Mori & Tomotsune** is a full-service law firm formed by the combination of three leading law firms in Japan: Anderson Mori, one of the largest international firms in Japan, serving overseas companies doing business in Japan since the early 1950s; Tomotsune & Kimura, well known for its expertise in international finance transactions; and Bingham Sakai Mimura Aizawa, a premier international insolvency/restructuring and crisis management firm. The firm is proud of its long tradition of serving the international business, and of its reputation as one of the largest full-service law firms in Japan. Its combined expertise enables the firm to deliver comprehensive advice on virtually all legal issues related to corporate transactions. The majority of the lawyers are bilingual and experienced in drafting and negotiating across borders and around the globe.

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# MEXICO

## Law and Practice

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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Principal Legal Framework

The principal laws governing the banking sector in Mexico are:

- The Banking Law (*Ley de Instituciones de Crédito*) which, among others, sets forth the general framework governing banks (*instituciones de crédito*) including their incorporation and authorisation, governance, ownership, mergers, spin-offs, business activities, insolvency and resolution. The Banking Law also establishes the scope of authority of the different governmental entities that regulate and supervise banks and their activities.
- The General Law of Negotiable Instruments and Credit Transactions (*Ley General de Títulos y Operaciones de Crédito*) sets forth the legal framework governing negotiable instruments, such as promissory notes, cheques, other debt instruments, repurchase transactions, cash and security deposits, credit transactions (ie, loan facilities, revolving lines of credit and letters of credit), pledges, trusts, leases and factoring.
- The Bank Savings Protection Law (*Ley de Protección al Ahorro Bancario*) which governs the bank savings protection system.
- The Financial Services User Protection and Defense Law (*Ley de Protección y Defensa al Usuario de Servicios Financieros*) which sets forth the general framework for the protection and defense of financial service users.

Although banks are heavily regulated, the most relevant regulations concerning their operations are:

- The general rules applicable to banks (*Disposiciones de carácter general aplicables a las Instituciones de Crédito*) issued by the National Banking and Securities Commission (Commission), that, among others, setforth the capitalisation, internal control and reporting obligations of banks;
- The different regulations issued by the Central Bank of Mexico, notably Circular 3/2012, which regulates passive and active operations of banks, and Circular 1/2005 that sets forth the rules banks must follow in connection with trusts; and
- The Anti Money Laundering Rules (*Disposiciones de carácter general a que se refiere el artículo 115 de la Ley de Instituciones de Crédito*), which set forth the rules that must be followed by banks in connection with their knowledge and identification of clients and customers, reportable transactions and their anti-money laundering policies and procedures.

### Principal Authorities

The principal authorities responsible for supervising banks in Mexico are:

- The Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*); responsible for designing and conducting the policies of the Federal Government of Mexico on financial, tax, expenses, income and public debt. The Ministry of Finance, through its Financial Intelligence Unit (*Unidad de Inteligencia Financiera*), is in charge of regulating banks and other financial entities in connection with anti-money laundering matters (although, compliance with these regulations is within the scope of authority of the Commission);
- The Central Bank of Mexico (*Banco de México*) which, within its broad scope of authority as central bank, is in charge of promoting the proper functioning of the financial and payment systems;
- The Commission; in charge of regulating, inspecting and overseeing banks;
- The National Commission for the Protection and Defense of Financial Services Users (*Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros*); in charge of the protection and defense of users of the services provided by banks and other financial institutions; and
- The Institute for the Protection of Bank Savings (*Instituto para la Protección al Ahorro Bancario*), which manages a deposit insurance available to accountholders in case a bank becomes insolvent. The institute will act as the liquidator of banks in Mexico.

# 2. Authorisation

## 2.1 Licences and Application Process

### Authorisation Requirements

The organisation and operation of a bank in Mexico requires authorisation from the Commission. Prior to granting the authorisation, the Commission must have a favourable opinion of the Central Bank of Mexico for the project. The granting of a bank authorisation is a discretionary authority of the Commission and such authorisations are non-transferable.

Foreign banks are not allowed to provide banking and credit services through locally established branches, but rather need to establish a subsidiary.

### Types of Authorisations

Outside of development banks, which are owned by the Federal Government, the Banking Law provides for two types of bank authorisations: (i) banks (*instituciones de banca múltiple*); and (ii) affiliate banks (*instituciones de banca múliple filiales*). There are very minor differences between these two licenses with regard to their corporate organisation, activities and regulation. However, the quantity of information required from the owners of an affiliate bank in the process of authorisation is significantly reduced. Affiliate banks are owned and controlled by a bank established in a foreign country that has entered into a treaty with Mexico. This treaty must contain a provision allowing for the establishment of affiliate banks.

#### Activities and Services Covered

Article 46 of the Banking Law sets forth a comprehensive list of activities (including active and passive transactions and financial services) that banks are allowed to perform. Banks must include in their by-laws the list of activities that they intend to perform. The minimum equity capital requirement for each bank will depend on the activities included in their by-laws. Bank regulations establish three different predefined sets of permitted activities that banks can elect to include in their by-laws. These predefined sets can be summarised as follows:

- banks that consider to be their activities the permitted activities (Universal Banking) that have the largest minimum equity capital requirement;
- banks that perform all traditional banking activities but do not perform any securities transactions on behalf of third parties or any non-banking services, and to which there is a lesser capital requirement; and
- banks that only perform deposit and custody services for legal entities and qualified and institutional investors; investment banking (at least, similar to the general concept of investment banking), or issuance of payment means for which there is an even lesser capital requirement.

Any other combination of permitted activities requires the bank to have the same minimum equity capital as that of the banks that elect to include all of the permitted activities in their by-laws.

The most significant restrictions for banks are basically (i) the prohibition of acting as underwriters in public offerings of securities; and (ii) the prohibition of issuing insurance policies.

#### Authorisation Process

The process of authorisation is carried out with the Commission and takes from 9-12 months. Operations usually commence within 18-24 months after the project has started. The authorisation process involves the stages listed and described below:

- first stage; the initial stage requires general definitions of: (a) the corporate structure of the bank, including the activities that it will perform; (b) the business purposes and feasibility of the project; and (c) the information technology strategy. Meetings with officers of the Commission are held at this stage in which the project is presented;
- second stage; this stage of the process involves the preparation of a preliminary filing of the application to the Commission. Generally, the application requires the following:
  - (a) detailed information concerning the direct and indirect shareholders, including financial and tax information and evidence of the licit source of the funds that will be invested in the bank;
  - (b) the shareholding structure;
  - (c) detailed information concerning the members of the board of directors, examiners (*comisarios*), CEO and the officers within the two hierarchical levels below the latter. The appointment of directors and officers will be subject to them passing professional, credit and criminal background checks;
  - (d) a business plan, general operations plan, and financial projections;
  - (e) a surety deposit equivalent to 10% of the equity capital of the bank, returned to the applicants upon commencement of operations and incapable of accruing interest; and
  - (f) the filing fees of approximately USD2,500;
- third stage; once the comments by the financial authorities are incorporated, the application is officially filed with the Commission;
- fourth stage; the authorities make final comments and the applicants make additional filings addressing them; and
- fifth stage; the Commission issues the authorisation.

Thereafter, the bank has 90 days to approve the executed deed of its incorporation. Within 180 days following the approval of the deed of incorporation, the bank requests the Commission to authorise its commencement of operations. Such authorisation involves a visit of officers from the financial authorities to the bank to test its operations.

At this stage, the applicants must pay the Commission a fee of approximately USD36,500 for the issuance of the Bank authorisation and a fee of approximately USD100,000 for the authorisation to commence operations.

After receiving the authorisation to commence operations, the bank may start doing business with the public.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

The acquisition and transfer of a bank in Mexico's shares is subject to the following rules and requirements:

- acquisitions or sales of less than 2% of the common shares of a bank do not trigger any regulatory requirement;
- the acquisition or transfer of 2% or more, but less than 5%, of the common shares of the bank require the transferor and the acquirer to give notice to the Commission within three days of completing the transfer;
- direct or indirect acquisitions of (or the creation of collateral over) 5% or more, but less than 20%, of the common shares of the bank require a prior discretionary authorisation from the Commission. The Commission will perform a thorough business, financial and criminal background check of the applicants during the process of authorisation; and
- the direct or indirect acquisition of 20% or more of the common shares, or the acquisition of control of a bank by a person or group of persons requires prior authorisation from the Commission. The Commission will perform a thorough business, financial and criminal background check of the applicants during the process of authorisation and will review information on the directors and officers that the applicants would intend to appoint, along with any changes that the applicants intend to make to the general operation plan and the internal control system of the bank.

Pursuant to the Banking Law, control over a bank is the ability to impose, directly or indirectly, decisions at the shareholders' meeting. This includes the authority to exercise the voting rights of more than 50% of the shares and the authority to direct, administration, strategy and principal policies of the bank, whether through the ownership of securities or through any other legal means.

In addition, the acquisition of shares or the control of a Mexican bank could require authorisation from the Federal Economic Competition Commission for antitrust matters. Likewise, the acquirer should consider the reporting and investment thresholds of the Securities Market Law (*Ley del Mercado de Valores*) if the shares of the bank are traded in a Mexican stock exchange.

Banks are not restricted from having foreign investors in their equity capital. Notwithstanding, foreign governments are only allowed to participate, directly or indirectly, in the stated capital of banks in Mexico when:

- the investment is made pursuant to temporary financial relief programs;
- the participation is indirect and does not represent a controlling interest of the bank; and
- the National Banking and Securities Commission, at its discretion, approves a participation that implies control over the bank, and is made through official legal entities such as funds and development governmental entities subject to:
  (a) the investors proving they do not exercise authority functions; and
  (b) its decision-making corporate bodies operate independently from the relevant foreign government.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Corporate Governance of a Bank

The board of directors is the principal corporate body in charge of the corporate governance of a bank in Mexico. The board of directors must be integrated by no fewer than five and no more than 15 statutory members from which at least 25% (rounded upwards) must be independent. Independent Board Members is a concept of corporate governance that requires certain board members not to have any professional, business, commercial or family relationship with other directors, the shareholders or other stakeholders of the bank. The number of officers of the bank that can form part of the board is limited to one third. For each statutory director an alternate director can be appointed, in the understanding that the alternates of independent directors also qualify as independent directors. The board of directors is required to have a meeting at least every quarter and whenever necessary.

The board of directors is required to have certain committees with advisory duties. The bank must have a minimum of an audit committee, a risk committee, a compensations committee (whose functions, subject to complying with certain requirements, may be performed by the risk committee), a communication and control committee (in charge of know-your-customer and anti-money laundering matters) and a related-party transactions committee.

These committees are auxiliary committees to the Board of Directors and require that one or more of its members be directors. In the case of an audit committee, all of its members must be directors and the majority of them, including the chairperson, must be independent.

The board of directors, at the audit committee's proposal, is responsible for establishing the objectives and guidelines of the internal control system. The CEO is responsible for implementing the internal control system throughout the organisation. Once implemented, the audit committee is responsible for submitting for the board's approval the organisational chart, the code of conduct, the appointment of the external auditors and evaluation reports of the internal control system.

The internal audit department, independent of the CEO, is responsible for reviewing both periodically and systematically the internal control system while reporting findings and implemented actions to the audit committee.

A bank's financial information and its control systems are reviewed annually by external auditors and *comisarios*. The latter are persons appointed by the shareholders' meeting in charge of overseeing the performance of the board of directors in connection with the internal control system.

## 4.2 Registration and Oversight of Senior Management

Directors of a bank in Mexico can only be appointed by the shareholders' meeting. Pursuant to the Banking Law, all directors need to have technical capabilities, honorability, satisfactory business and credit history and ample financial, legal or administrative knowledge. Most directors of banks in Mexico must be local residents.

No person can act as director for two banks, or financial group holding companies that own banks, at the same time. The director must inform the shareholders meeting if he or she is the director of another financial entity.

Officers of a bank, including the CEO and all officers within the two hierarchy levels below the CEO, must be residents of Mexico with evidence of at least five years of previous professional experience in positions of high decision-making.

### Authorisation Process

During the authorisation process of a new bank or during a change of control processes, the proposed directors, CEO and senior officers of the bank must submit for the consideration of the Commission predefined forms and letters as well as supporting documentation showing:

- personal identification information and immediate family names and relationships;
- educational background;
- professional experience background;
- credit score reports;
- absence of criminal records; and
- taxpayer registration.

Likewise, each director and officer will need to sign a letter addressed to the Commission, with representations as to their honorability and creditworthiness, authorising the Commission to verify all information provided with the corresponding national or foreign authorities.

The Commission has the right to request additional information as it deems convenient, and may approve or reject the proposed appointment at its discretion.

### Ordinary Course

In the ordinary course of business, any appointments of directors or officers must be communicated to the Commission within five business days. In this case, it is the bank that must verify and ensure the proposed director or officer's compliance with all of the requirements established by law.

The Commission can request the removal of any officer or director that does not comply with the applicable requirements. This can be either at the time of the appointment or at any time thereafter, and can ban them from occupying any positions in the financial sector.

The bank must always open and update, at least annually, a file for each director and officer, containing all the information and documentation meeting the applicable requirements.

## 4.3 Remuneration Requirements

### Remuneration System

Banks must permanently implement, maintain and monitor a remuneration system consistent with effective risk management. The purpose of a bank in Mexico's remuneration system is to ensure that the ordinary and extraordinary remuneration of its employees, administrative departments, control and business areas and other employees takes into consideration the actual and potential risks related to the individual activities of such employees.

The remuneration system must consider all remuneration, whether in cash or otherwise. It forms part of the internal control system, and is ultimately overseen by the board of directors, which is advised on these matters by the remuneration committee, chaired by an independent director.

Unusual remunerations that are determined by individual performance or that of a particular department must not consider exclusively the results of the financial year in which the transactions occurred but also the risks and results seen during a reasonably longer period of time. To this extent, performance reviews must be consistent with and based on results adjusted by present and future risks, liquidity, capital costs and other considerably appropriate variables.

The remuneration system must be flexible enough so as to allow the bank to reduce or suspend the payment of extraordinary remunerations whenever the bank faces losses or the risk impacts are greater than expected.

A bank's remuneration system must be updated every year and must be made available to the public via its webpages. The information included must portray a thorough description of the remuneration system, including qualitative and quantitative information and a mention to the actual remuneration amount paid during the relevant fiscal year, indicating if such remuneration were (i) fixed or variable; (ii) paid or deferred; and (iii) in cash, stock, other equity instruments or otherwise.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

**Anti-money Laundering and Counter-Terrorist Financing Framework**

The anti-money laundering and counter-terrorist financing (AML/CTF) framework applicable to Mexico is founded on a risk-based approach. Mexican banks must assess their AML/CTF risks yearly, taking into consideration the following elements:

- products and services;
- clients (ie, individuals and entities with a sustained, contractual relationship with the bank) and users (persons who do not have contractual agreements with the bank);
- geographical areas in which the bank operates; and
- transactional and operational channels.

**Identification and Follow-Up of Counterparties**

Another AML/CFT requirement for banks in Mexico is the conduction of due diligence and know-your-customer exercises. The scope and degree of the due diligence and know-your-customer requirements depends on whether they are conducted on:

- clients or users;
- individuals, legal entities, or trusts; and
- Mexicans or non-Mexicans.

There are simplified due diligence measures available and exemptions to it according to the client's risk of AML/CTF. There are banking account levels, which begin with reduced due diligence requirements, subject to less transactional levels. The permitted transactional level of accounts increases along with the increase in the depth of due diligence requirements. This regulation aims to bolster financial inclusion in the country.

Before COVID-19, banks did not have the widespread ability to start a client relationship remotely. However, the Commission has recently enacted rules that allow banks to remotely execute operations and agreements as long as they verify certain biometric information of the customer's IDs, vis-à-vis the information in official records held by authorities like the National Electoral Institute (which issues the most commonly accepted photo identification in the country).

Regarding know-your-customer requirements, banks must regularly assess whether their clients have their identifications and documents updated and their transactional behaviour in order to determine the risk they entail to the financial institution.

**Internal Structures**

Banks must keep internal structures, policies, controls, and procedures against financial crime including the following lines of defense:

- a compliance officer, who serves as the link with the authorities (particularly, the Commission and the Financial Intelligence Unit);
- a communications and control committee, which oversees the correct implementation of the AML/CFT measures within the bank;
- an external or internal auditor; and
- ultimately, the board of directors, responsible for establishing the general strategy in respect of AML/CFT matters.

Banks must have AML/CFT manuals and training in place, which are regularly shared with the Commission.

**Reporting to Authorities**

Banks are required to make the following periodic filings of AML/CFT reports:

- relevant operations reports, when identifying transactions of USD7,500 or more;
- suspicious transactions reports;
- internal operations reports, to be filed whenever a conduct or omission by a bank's employee could be contrary to the AML/CFT framework;
- reports of transactions with virtual currencies, as well as with US dollars in cash; and
- reports about international transfers of funds and operations with cashier's cheques.

All these reports have specific thresholds, deadlines and conditions when being filed for the Commission.

**Dollar – Peso Exchange**

Due to the risk of illicit activities between Mexico and the United States, Mexican authorities have implemented restrictions so that Mexican banks are usually restricted to receiving US dollars in cash, except when there is an economic rationale provided in the regulation, ie, receiving funds from legal entities with branches near the border.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

The Bank Savings Protection Law (*Ley de Protección al Ahorro Bancario*) provides for the creation, organisation and functions of the Bank Savings Protection Institute. Said Institute is in charge of managing the savings protection fund.

Bank liabilities that are guaranteed by the Bank Savings Protection Institute are mainly on demand and term deposits, savings accounts and revolving deposits associated to debit accounts, but only up to the amount of 400,000 inflation adjusted units (known as "UDIs"), per person — or legal entity — per bank (approximately, USD132,000).

The deposit insurance to be provided by the Bank Savings Protection Institute to a bank's depositors will be paid upon determination of the resolution of a bank. Upon payment, the Bank Savings Protection Institute acquires the claim of the depositor against the relevant bank. Any amount not paid by the Bank Savings Protection Institute can be claimed directly by the depositor from the relevant bank.

Obligations of banks in favour of financial entities, companies within the same financial group as the bank, shareholders, board members, CEO and the officers within the immediately following hierarchy level, general managers and attorneys-in-fact of the bank are not insured by the Institute. In addition, liabilities documented in negotiable instruments, bearer notes, transactions performed outside the applicable legal, regulatory and administrative framework, bank liabilities that are not within standard banking customs and practice and any operation related to illegal acts or transactions are not covered by the deposit insurance.

The deposit insurance is exclusive to bank liabilities and, therefore, does not cover financial products such as mutual funds, insurance products and other liabilities of other financial entities, even if the bank acts as distributor of such products.

Banks have the obligation to pay to the Bank Savings Protection Institute ordinary and extraordinary contributions as determined from time to time by the governing board of the Bank Savings Protection Institute. All banks must make monthly ordinary contributions to the Bank Savings Protection Institute in an amount equal to 0.004 of the bank's deposits and certain other liabilities. Calculating the standard contribution amount is done by subtracting the following from the total account of each bank's liabilities:

- term debt instruments issued by other commercial banks;
- loans to other commercial banks;
- loans from the Bank Savings Protection Institute;
- mandatorily convertible debentures issued by commercial banks; and
- certain future operations.

The Bank Savings Protection Institute may also impose extraordinary contributions on banks, which may not exceed in any one year 0.003 of the deposits of the banks. Extraordinary contributions may be imposed by the Bank Savings Protection Institute when given the then prevailing conditions of the Mexican banking system, said institute does not have sufficient resources to satisfy its obligations. Extraordinary contributions may be imposed by the Bank Savings Protection Institute when, given the then prevailing conditions of the Mexican banking system, said institute does not have sufficient resources to satisfy its obligations. Both ordinary and extraordinary contributions, in the aggregate, shall not exceed 0.008 of the liabilities of a bank on any one year.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

### Bank Secrecy Framework

Banks in Mexico are subject to very strict secrecy rules concerning their customers. Pursuant to the Banking Law, banks in Mexico may not provide any news or information of the deposits, bank operations or services including trusts, to the depositor, debtor, account holder, beneficiary, settlor or principal, their respective legal representatives, or to the persons that have been legally authorised to withdraw from the relevant account or to be involved in the corresponding transaction or service.

This secrecy obligation is not related to the reporting obligations of banks with the Commission, the Central Bank, the Bank Savings Protection Institute and the regulators of Mexican banks.

Likewise, the secrecy obligation of Banks will not be considered breached when information is provided to judicial authorities pursuant to court-issued orders in judicial procedures in which the account holder, settler, beneficiary, trustee or agent is either a plaintiff or a defendant. Furthermore, banks will be exempted from their secrecy obligations and are consequently required to provide information requested by any of the following authorities, typically through the Commission:

- the Federal Attorney General, local attorney generals or the Military Attorney General, for purposes of evidencing a fact constituting a felony or the probable responsibility of the defendant;
- the federal tax authorities for tax purposes;

- the Ministry of Finance and Public Credit for AML/CFT purposes;
- the Federal Treasurer, for purposes of obtaining statements of account and any other information concerning the private accounts of public servants, other servants and private parties;
- the federal comptrollership, in exercise of its investigation and audit authority to verify the growth of assets of the federal public servants;
- the Superior Auditor of the Federation; and
- the Federal Electoral Institute, in exercise of its legal duties.

Information and documents provided by banks to the authorities in connection with the bank secrecy exemptions described above may only be used in the proceedings and for the purposes indicated in the relevant request. The persons that acquired knowledge of such information and documents are required to keep them strictly confidential, even if they cease to be public servants. Any breach of this obligation will subject the relevant person to the applicable administrative, civil or criminal responsibilities as provided by law.

In addition, the Banking Law expressly allows the Ministry of Finance and Public Credit, the Commission, the Bank Savings Protection Institute, the Central Bank, and the National Commission for the Protection and Defense of the Users of Financial Services, within their respective scope of authority, to provide to foreign financial authorities any and all information acquired by said Mexican authorities in the performance of their functions. This is provided that the relevant Mexican authority and the relevant foreign financial authority have entered into reciprocity agreements.

### Non-compliance

Employees and officers of banks responsible for breaches to the secrecy rules and the relevant bank will be required, in the case of any undue disclosure of bank secrets, to pay for the damages and lost profits caused by such breach.

In addition, non-compliance by a bank with the bank secrecy provisions set out in the Banking Law is considered a gross default and can be sanctioned with fines imposed by the Commission, ranging from approximately USD130,000 to approximately USD435,000.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Capitalisation of Banks in Mexico

The Banking Law requires banks in Mexico to maintain a regulatory capital, expressed as an index (the capital adequacy ratio or “ICAP”), that shall in no case be less than the sum of the capital requirements associated with (i) market, credit, operational and other risks incurred by banks in their operation; and (ii) their ratio of assets to liabilities.

The Commission, along with other financial authorities in Mexico, has implemented regulation in order to strengthen the composition of the net capital of banks in a manner consistent with the guidelines set forth in the Capital Agreement issued by the Basel Banking Supervisions Committee (Basel III Agreement).

Banks in Mexico are required to maintain a minimum capitalisation index, or ICAP, of 8%. The regulatory capital is comprised of Tier 1 and Tier 2 capital. The Common Equity Tier 1 capital must be at least 6%, while the Additional Tier 1 capital ratio must be of 4.5%. In addition, banks must maintain a capital conservation buffer of 2.5% of Additional Tier 1 Capital.

Based on their ICAP, their Common Equity Tier 1 and Additional Tier 1 capital ratios, the Commission will classify banks into different categories. Such classification may trigger minimum corrective measures and additional special measures that banks must observe in order to improve their capitalisation. Such corrective measures can include restrictions to the payment of dividends and other distributions to the shareholders of the bank, as well as in extraordinary remuneration for the employees and directors of the bank. In addition, corrective measures may include a requirement to file a capital conservation plan or a capital restructure plan for banks that are classified within Category III or lower.

### Banks of Local Systemic Relevance

If the Commission determines that a potential noncompliance of the obligations of a particular bank could pose a risk for the stability of the Mexican financial system, payment system or for the economy of the country, said bank will be classified as being of Local Systemic Relevance (*Instituciones de Banca Múltiple de Importancia Sistémica Local*). Local Systemic Relevance Banks will be classified within different degrees of systematic relevance and will be required to add to their capital conservation buffer an additional percentage of the aggregated risk-weighted assets based on the assigned degree of systematic relevance. This additional percentage will range from 0.60% to 2.25%.

**Risk Management**

Banks are required to establish risk management mechanisms that allow them to perform their activities with risk levels consistent with their regulatory capital, liquid assets and operational capabilities under normal, adverse and extreme conditions. For said purposes, risk management processes implemented by banks must maintain, both systematically and prospectively, the risk level of their principal transactions within their solvency, liquidity and financial feasibility limits, and their accordance with their desired risk profile. Banks must reestablish the risk level whenever a deviation occurs.

Banks classify their risks into the following three categories:

- quantifiable risks; credit liquidity, market and concentration risks;
- discretionary risks; technology and legal risks; and
- non-quantifiable risks: strategic, business and reputational risks.

Banks are required to maintain a capitalisation structure that allows them to cover potential losses derived from all of the risks to which they are or may be exposed under different scenarios, including those in which adverse economic conditions prevail. For these purposes, banks are required to conduct annual stress tests to assess whether they have the necessary capital, and to design and maintain a contingency plan (similar to living wills in other jurisdictions) that must be approved by the Commission.

**Risk Structures**

The board of directors of the bank is responsible for approving the desired risk profile, the risk management framework, the risk exposure levels and the risk tolerance levels, as well as contingency plans (including the contingency financing plan). The board of directors is also responsible of overseeing that the bank has sufficient capital to cover all of its risk exposure.

The CEO is responsible for ensuring that the business units and the risk management department of the bank remain independent from each other at all times, and for coordinating the risk management programs and duties.

The board of directors must create a risk committee that shall oversee that all transactions performed by the bank are made within the desired risk profile, the integral risk management framework and the risk exposure limits approved by the board.

**Liquidity**

Banks are required to calculate their Liquidity Coverage Ratio measured in accordance with the Basel III Agreement. The liquidity obligations of banks in Mexico are outlined by the Bank Liquidity Regulation Committee and implemented by the Commission and the Central Bank. The Commission is also responsible for overseeing compliance with the liquidity requirements applicable to Banks.

The Bank Liquidity Regulation Committee is responsible for dictating the guidelines for the establishment of the liquidity requirements of banks. Such guidelines have the purpose of ensuring that banks will be able to meet their payment obligations in different terms and under different scenarios, including under economically adverse conditions. This committee is integrated by high-level officers of the Ministry of Finance, the Central Bank and the National Banking and Securities Commission.

Banks must have a financial contingency plan, as part of their risk management system, that clearly sets out the strategies and policies to be observed and the procedures to follow in case of unexpected liquidity events or trouble liquidating assets. This financial contingency plan must be submitted annually to the Commission, which can subsequently order that changes and amendments are made to it.

In case a bank is not compliant with its liquidity obligations or determines that it will not comply with them in the future, it shall immediately notify the Commission thereof. In this case, the Commission may require the relevant bank to:

- inform the Commission and the Central Bank of the causes for such non-compliance;
- inform its board of directors of its liquidity condition and the causes for any instances of non-compliance;
- submit for the consideration of the Commission a liquidity restoration plan;
- suspend distributions (including dividends) to its shareholders; and
- implement other measures ordered by the Commission.

Furthermore, the Commission can impose additional measures on banks that have a Liquidity Coverage Ratio of less than 90%.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

Banks in Mexico must have certain minimum levels of capital. Capital requirements concern both the minimum equity capital and the regulatory capital a bank must have. Capitalisation is an important indicator of a bank's financial health, a reduction of which, depending on its level, could (i) trigger "early warnings"; (ii) entitle the bank to apply for a conditioned operation regime; or (iii) subject the bank to a resolution process.

Once a bank's capitalisation index falls below ten percent, said bank will be subject to minimal corrective measures or special additional corrective measures imposed by the Commission, depending on its actual level of capitalisation. Minimal corrective measures include notifying the board of directors; submitting a recapitalisation program to the Commission; suspending payment of dividends, interests of hybrid instruments and bonuses; and refraining from making capital investments.

Special additional corrective measures include hiring external auditors; refraining from increasing compensation and entering into certain types of transactions; substituting officers, directors and auditors; carrying out transactions to reduce exposure to risk; and amending deposit-taking policies.

A bank with capitalisation below 8% (but higher than 4.5%) may apply to continue as an ongoing business under a conditioned operation regime. To have access to the conditioned operation regime, the bank shall (i) file an application with the Commission; (ii) cause at least 75% percent of its shares to be placed in a trust; and (iii) prepare and submit a recapitalisation plan.

The trust referred to in (ii) above shall allow the Bank Savings Protection Institute to exercise economic and corporate rights of those shares if (i) the Commission rejects the recapitalisation plan; (ii) the Commission determines that the bank has not complied with the approved recapitalisation plan; (iii) the bank's ICAP falls to or below 4.5% percent; or (iv) the bank does not comply with one minimum corrective measure, or fails to comply with its payment obligations.

The trust will be terminated once the bank reaches and maintains in three consecutive months the minimum required ICAP. The bank must otherwise undergo a resolution process.

### Bank Resolutions

The resolution of a bank consists of the actions or procedures implemented by the financial authorities on a bank that is facing solvency or liquidity issues that affect its financial viability. These actions or procedures ensure a proper liquidation (or in certain exceptional cases its restoration) for the protection of depositors, the financial system stability and the proper functioning of the payment systems.

Generally, a bank resolution process will conclude with the administrative or judicial liquidation of the bank. In exceptional cases, the bank will be rehabilitated. As a general rule, once the Commission has revoked the bank's authorisation, the Bank Savings Protection Institute will determine whether the liquidation of the bank shall be judicial or extrajudicial. Notwithstanding, if the Bank Stability Committee determines that a potential default in the bank's obligation could trigger negative or adverse effects in other banks or financial institutions, comprising their stability or solvency and as a consequence the stability or solvency of the financial system or the proper functioning of payment systems, the resolution method can be either:

- the rehabilitation of the bank through equity capital provided by the Bank Savings Protection Institute, provided that the bank applied for a conditioned operation regime; or
- through loans granted by said Institute if the bank did not.

In the case of supportive equity contributions, the Bank Savings Protection Institute will initiate the selling of a bank's shares — including those of its shareholders —following the rules set out in the Banking Law. If the Bank Savings Protection Institute provides a loan to the relevant bank, all of the shares issued by the bank will secure the loan until the shareholders of the bank subscribe and pay a capital increase to pay for said loan. If the shareholders do not make this contribution, the Bank Savings Protection Institute will automatically acquire the shares and will sell them thereafter in accordance with the rules set out in the Banking Law.

### Liquidation of the Bank

The Bank Savings Protection Institute will act as the liquidator of the bank and will generally be responsible for terminating and concluding all pending businesses of the bank. This includes the settling of accounts and the disposition of rights and assets, with a goal to obtain the best price or conditions in connection therewith under strict transparency rules.

In doing the above, the Bank Savings Protection Institute can elect to proceed with the transfer of all or some the assets and liabilities of the bank to another existing bank or to a bank created for such purposes by the Bank Savings Protection Institute, or any other transaction that the Bank Savings Protection Institutes considers as the best option to protect the interests of depositors.

When making any of the foregoing decisions, the Bank Savings Protection Institute will ensure that the cost of any such decision is less than the total estimated cost of paying the deposit insurance over all insured deposits of the bank.

In all instances, the Bank Savings Protection Institute will ensure that all insured deposits are covered in the terms required by law to all depositors.

### Claims

All actions of the authorities in the process of the resolution and liquidation of banks in Mexico are considered to be of public order and social interest. Claims against such actions do not subsequently carry the possibility of suspension. In case a claim against such actions prevails, the claimant will only be entitled to the payment of damages and losses.

# 10. Horizon Scanning

## 10.1 Regulatory Developments

### Differentiated Regulation

As explained above, the required minimum equity capital of banks in Mexico varies depending on the activities that each bank elects to include as part of its corporate purpose.

Permitted activities of banks are set out in Article 46 of the Banking Law (the Permitted Activities). Pursuant to said article, banks are authorised to:

1. take cash deposits:
- on demand;
- returnable by a specified date;
- for saving purposes; and
- for a certain term or payable with prior advance notice;
1. take loans and credits;
2. issue bank notes and debentures;
3. issue subordinated obligations;
4. make deposits to foreign banks and financial institutions;
5. enter into discount transactions and grant loans and credits;
6. issue credit cards based on revolving facilities;
7. assume obligations on behalf of third parties based on loans granted through acceptances, endorsements or guarantees of negotiable instruments as well as through letters of credit;
8. perform transactions with securities;
9. promote the organisation and transformation of all types of entities or companies, and to subscribe and hold equity participations in them subject to the provisions of the Banking Law;
10. perform all transactions on its own behalf with any commercial documents;
11. perform transactions with gold, silver and foreign currencies, including any repurchase (*reporto*) transactions concerning foreign currencies;
12. facilitate safety-deposit boxes;
13. issue pre-funded letters of credit;
14. act as trustee;
15. receive any deposits whether for administration, custody or guaranty on behalf of third parties of any negotiable instruments and shares and generally of all commercial documents;
16. act as common representative of the holders of negotiable instruments;
17. perform treasury and cashier services in respect of negotiable instruments on behalf of the issuers thereof;
18. perform the accounting and bookkeeping for any companies or entities;
19. act as executor in inheritance procedures;
20. act as receiver and liquidator of businesses, premises, bankruptcy and inheritance estates;
21. perform appraisals;
22. acquire the necessary real estate assets and equipment for the accomplishment of their purpose and to manage such assets as deemed convenient;
23. enter into financial leasing transactions and to acquire the assets related to such transactions;
24. enter into derivative transactions in accordance with the rules issued by the Central Bank for such purposes;
25. perform factoring activities;
26. issue any payment means determined by the Central Bank;
27. participate in the selling of insurance, subject to the applicable insurance laws; and
28. engage in other similar or related activities authorised by the financial authorities.

In connection with the Permitted Activities, the Banking Law and the related provisions consider the following options:

- banks that expressly include in their by-laws the performance of all of the Permitted Activities must have a minimum paid-in equity capital of ninety million UDIs (approximately, USD30 million);
- banks that elect to include in their by-laws only those Permitted Activities identified in items: (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), (xi), (xxiii), (xxiv), (xxv) and (xxvi), as a predefined set of Permitted Activities, must have a minimum paid-in equity capital of 54 million UDIs (approximately USD18 million). In addition, these banks may also elect to include one or more of the following Permitted Activities: (ix), but only for its own account and not for the account of third parties, (x), (xii), (xiv), (xv), (xvi), (xxii) and, when intended only for the achievement of its corporate purpose, (xxix);
- banks that elect any of the following predefined sets of Permitted Activities must have a minimum paid-in equity capital of 36 million UDIs (approximately USD12 million): (a) Permitted Activities (i), (ii), (iv) and (xvi) but exclusively from and with qualified and institutional investors and legal entities; (b) Permitted Activities (v), (ix), (x), (xi), (xii), (xv), (xvii), (xviii), (xix), (xx), (xxi), (xxii), (xxiii) and, when necessary for the accomplishment of their corporate purpose, (xviii); (c) Permitted Activities (i)(a), (ii), (v), (vi) only in respect of the granting of loans and exclusively for transactions entered into with other banks, (ix), but limited to sovereign or bank bonds acting for its own account and not for the benefit of third parties, (xi), (xii) but limited only

to foreign currencies; (xxiii), and (xxvii) and (xxviii) only for purposes of achieving its corporate purposes; and
- (iv) banks that elect any other combination or election of Permitted Activities will require the relevant bank to have a paid-in equity capital of 90 million UDIs (or approximately USD30 million).

Notwithstanding the differentiation of banks with respect to their minimum paid-in equity capital and the requirements regarding their permitted activities, all banks in Mexico irrespective of their size, footprint, or business model are subject to exactly the same set of financial, internal control, compliance, and reporting regulations. An exception to this is the very specific set of measures imposed on systemically important banks, as described above. The current regulatory framework of banks does not establish differentiations of the regulatory framework, based on the Permitted Activities, that each bank decides to consider in its corporate purpose, and much less on their size, business model, specialisation or otherwise.

Based on the foregoing, medium and smaller banks — and banks specialising in a particular product or business — have been requesting for some time the creation of a differentiated regulatory regime that recognises their specialised business model, market, and geographical presence. This would allow them to assume regulatory costs inline with their size and systemic relevance, allowing them more resources to invest in their product.

Despite the fact that this discussion has been taking place for numerous years, many key players in the financial market have been vocal about the issue and it is likely we will see an effort from both banks and the financial authorities (notably, the Commission) to achieve a differentiated regulatory framework among banks.

A differentiated regulatory framework will certainly have a significant impact on the banking sector and, while it certainly presents a major challenge for authorities, it could detonate the expansion and growth of small, medium and specialised banks.

### Financial Inclusion

The Mexican financial authorities have continued working towards creating an improved regulatory framework that addresses financial inclusion. This is one of the most urgent matters to address in Mexico, where a very low number of persons have access to formal financial services.

The efforts of the authorities in this respect have been and will continue to be focused on establishing adequate consumer protection mechanisms and financial education, while also providing for robust technology mechanisms to facilitate remote access and operations. Subsequently, the Mexican government has established a Financial Inclusion National Policy (*Política Nacional de Inclusión Financiera*). One of the Policy's objectives is to ensure that by 2024, 77% of Mexicans are the users of at least one formal financial product from an authorised financial entity. In order to achieve this goal, the Mexican government recognises the need for the private, social and public sectors of its society to work together.

It is likely that regulators will act to ensure that the principles of the policy are implemented and that banks, as well as other financial entities, can develop new channels and products to increase the number of persons that have access to and use financial services and products.

### Improvement of Existing Regulations

Along with the expansion of internet-based financial services and platforms, fintech entities and internet-based banking services, regulators will face the need for the improvement of the current financial services regulatory framework. This is not only regarding electronic access and information security, but also personal data protection, AML/CFT, especially with regard to know-your-client and identification procedures and tools, and financial services user protections.

### COVID-19

The Mexican financial authorities continue to work on addressing the impact of COVID-19. To this extent, both the Commission and the Central Bank have been implementing and have publicly indicated that they will continue to implement measures to promote the stability of the financial system, ensure that borrowers of banks and other financial intermediaries are afforded with the best possible conditions to allow for the payment of their loans, and establish countercyclical measures in the economic downturn seen during 2020.

Some of the foregoing measures implemented by the financial authorities are:

- establishing special accounting standards for banks to implement restructuring programs without having to create additional reserves;
- allowing for the deferral of payments of principal or interest for up to 6 months;
- creating new regulatory mechanisms to channel funds to lending activities for micro, small and medium enterprises;
- allowing for the remote opening of bank accounts by legal entities without any restrictions to their transaction levels; and
- granting exceptions to banks to charge and collect minimum payments under revolving lines of credit associated with credit cards.

It is expected that in the short-term additional programs, borrowers who need to can access a restructuring program, and banks will be able to benefit from temporary exceptions to the regulatory framework to accommodate the restructuring or refinancing needs of its clients and customers.

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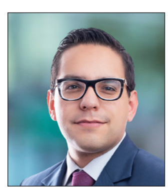

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# Trends and Developments

***Contributed by:***
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## Trends and Developments in the Banking Regulatory Environment Associated with COVID-19

The regulatory environment of financial institutions has been principally focused on addressing the impact of COVID-19 in the Mexican banking sector. As the principal regulators of banks, the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, the "Commission") and the Central Bank (*Banco de México*) have been very active in addressing the needs of both the banks and their customers and clients. Through the enactment of regulation, both the Commission and the Central Bank, within their particular scope of authority, have issued resolutions aiming to protect the interests of borrowers and depositors of banks; establishing reasonable actions to minimise the impact of safe distancing on Mexico's economy; and reinvigorating credit granting activities as a countermeasure to the reduced economic activity observed as a consequence of the pandemic.

## The Commission

The Commission has enacted different rules applicable to banks with the purpose of either:

- assisting banks in dealing with the implications of clients that are unable to satisfy their payment obligations; or
- providing operational guidelines to facilitate the day-to-day operations of banks practicing social distancing and shelter-in-place in response to COVID-19.

Some of the most relevant regulatory actions of the Commission are described below.

## Special Accounting Standards

The Commission has issued special temporary accounting standards that allow banks (among other financial entities) to implement programmes with the purpose of deferring, either totally or partially, payments of interest and capital for up to six months.

For this purpose, restructured or renewed loans will not be considered past-due loans. As a result, they will not require the creation of additional credit reserves and consequently will not affect the bank's statements or their capitalisation index.

Furthermore, all balances can cease to accrue interest as long as the relevant loan is classified as current as of 28 February 2020 and does not qualify as a related-party transaction.

Banks can defer the creation of reserves associated to actions that result in better payment conditions for their clients. Said actions would include, among others, remissions and discounts.

## Restructuring Programmes

The Commission has announced a programme available for banks that implement Institutional Restructuring Programmes in order to offer better credit conditions to their clients. This programme allows banks to report restructured loans, that comply with certain characteristics determined by the Commission, to credit scoring entities with a soft code rather than a hard code. The difference between these codes is that a soft code indicates that the payment problems of the borrower were associated to an emergency situation beyond their control, whereas a hard code would indicate that the restructuring of the loan was associated to the borrower's individual problems.

These measures are available for loans that are restructured pursuant to institutional restructuring programmes implemented by the bank that meet a list of conditions set forth by the Commission.

These benefits are available for disbursed balances as of 15 April 2020, from loans granted on or prior to 31 March 2020 that as of such date were considered current, are not related-party transactions and payments which were affected by the COVID-19 pandemic by 31 January 2021 at the latest. Consequently, these regulatory measures will not be applicable for disbursements made after 15 April 2020.

## KYC Simplification

Also within the scope of actions in response to the COVID-19 pandemic, the Commission has enacted extraordinary measures concerning know-your-customer requirements in connection with anti-money laundering and counter-financing of terrorism AML/CFT applicable to banks. These measures allow legal entities to open bank accounts and enter into contracts with banks without physical documentation. Prior to these measures, only individuals could enter into agreements with banks without delivering physical documentation.

Even though know-your-customer requirements have been changed to include remote transactions, the legal representative of the entity that is entering into the agreement with the bank needs to be fully identified in accordance with the applicable know-your-client rules and the policies of the bank.

For these purposes, rather than holding physical know-your-customer interviews with the client, banks may hold video calls that need to be recorded and conducted by bots or other artificial intelligence mechanisms.

### Biometric Databases

In an effort to strengthen banks' ability to enter into transactions remotely, hereby preventing identity thefts, a set of rules regarding the use of biometric data by banks was implemented recently by the Commission.

Said rules allow banks to maintain databases with biometric information of its clients as a means to verify their identity when entering into agreements or performing bank transactions. Banks are entitled to cross-check the biometric data of their customers with governmental authorities, such as the National Voting Institute.

In order to use biometric data as a valid form of identification from its clients, banks must verify the information with the corresponding governmental authority.

Banks have a nine-month period, commencing as of 13 October 2020, in which to file an application to the Commission for authorisation to remotely open bank accounts without transactional restrictions and consumer loans.

### Suspension of Terms

The Commission also implemented a suspension of terms for the attention of administrative procedures during most part of this year and has since the commencement of COVID-19, implemented a system — permitting the electronic filing of reports, applications and responses — that was non-existent prior to the current sanitary emergency.

### The Central Bank

The Central Bank has also been active in establishing temporary measures aiming to minimise the negative effects of COVID-19, as described below.

### Availability of Funds for Credit Granting Activities

In order to enhance credit granting channels in the context of COVID-19, the Central Bank has enacted a set of rules with the purpose of allowing banks (both multiple banking institutions and state-owned or development banks) to obtain financing from the Central Bank. The purpose of this financing is expanding their credit granting activities and boosting the availability of loans for individuals and micro, small and medium enterprises.

Funds received by banks under this temporary programme may only be used for the direct or indirect (through other non-bank intermediaries) of (i) new credit facilities in the form of loans, leases or factoring transactions with micro, small, and medium enterprises; (ii) increases of the foregoing forms of financing by means of restructurings or refinancing, with a particular focus on the smaller companies; or (iii) payroll, personal, automobile or mortgage loans for individuals.

Under this set of rules, banks are entitled to obtain such financing by making withdrawals from their mandatory monetary regulation deposit. This is maintained by each bank in accordance with the Central Bank. Once the available balance in the monetary regulation deposit of each bank is depleted, the bank will be able to enter into repurchase transactions over eligible securities in order to attain additional funds subject to the liquidity conditions of the relevant bank.

This temporary programme will remain effective until, at least, 28 February 2021.

### Flexibility for Minimum Payments under Credit Cards

Also in the context of COVID-19, the Central Bank has issued a set of temporary exceptions to the rules that require banks to collect minimum payment amounts in connection with credit card revolving lines. Pursuant to these temporary exceptions, banks — when agreed with their respective clients — may refrain from charging the minimum payment amount under revolving loans associated to credit cards during the months of April to September 2020.

An additional exception, applicable from October 2020 to January 2021, is that of revolving loans covered by bank-implemented programmes to improve the possibility of payment of said loans, and in which the bank and the relevant client have agreed to refrain from making such payment for the above referenced period.

Commencing on February 2021, the obligation of banks to charge and collect minimum payments will be reinstated.

### Electronic Issuance of Securities

The Central Bank has sanctioned a set of rules that allow for the electronic issuance of securities, left with depository institutions in Mexico.

While electronic messages and signatures have been legally recognised in Mexico for at least a decade, there was no formal rule enabling the electronic issuance of securities for their deposit with depository institutions.

The rules implemented by the Central Bank resolve this lack of implementing regulation and give both the deposit of physical securities and electronic securities the same legal effects.

### Suspension of Terms

In light of the effects of COVID-19, the Central Bank (*Banco de México*) has suspended the legal terms relating to its inspection visits, in connection with sanctioning administrative procedures, as well as the legal term of responding to information requirements on a progressive calendar ending in February 2021.

### General Market Trends

#### *Fintech and electronic banking*

Since 2018, the Mexican market has seen a very aggressive expansion of financial technology companies, both in number and in size. The fintech sector is growing rapidly and competing significantly with more traditional financial entities, such as banks. In response, we are seeing banks in Mexico making considerable investments in their electronic platforms, with some applying for licenses to establish purely electronic banks.

Regulators have been constantly passing reforms to improve legal framework in order to keep up with the technology value proposals offered by financial technology entities and banks. However, there is still a long way to go to achieve a legal framework that welcomes technological proposals in banking and other financial activities and promotes financial inclusion while ensuring appropriate levels of control and supervision by the authorities and protection to financial services users so as to maintain the stability of financial and payment systems. Furthermore, compliance with and implementation of international AML/CT standards in this environment is also a complex challenge from a regulatory perspective.

To this extent, it is our expectation that aside from the COVID-19-related regulations, we will be seeing significant developments from the perspectives of financial technology and AML/CT.

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WHITE & CASE

# SINGAPORE


## Law and Practice

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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

The Monetary Authority of Singapore (the MAS) is Singapore's central bank and the integrated regulator and supervisor of banks in Singapore. It is a statutory board established under the Monetary Authority of Singapore Act (Chapter 186 of Singapore) (the MAS Act), and is responsible for the micro-prudential supervision of individual financial institutions (FIs), including banks, and the macro-prudential oversight of the financial system as a whole.

### Licensed Banks

The conduct of banking business in Singapore is primarily regulated by the MAS under the Banking Act (Chapter 19 of Singapore) (the BA) and its subsidiary legislation.

Banks licensed under the BA are also required to comply with other regulatory instruments issued by the MAS. For licensed banks, these would be in the form of notices that impose legally binding requirements. Regulatory instruments in the form of guidelines, codes, practice notes and circulars technically do not have legal effect, but non-compliance with such instruments may result in the imposition of non-statutory sanctions or impact the MAS' overall risk assessment of the bank or person in question.

### Merchant Banks

It is currently also possible for FIs to be approved by the MAS under the MAS Act to operate as a merchant bank. Unlike licensed banks, merchant banks do not accept deposits or raise funds in Singapore dollars from the public.

The operations of merchant banks are governed primarily by the directives issued under the MAS Act (which have the same effect as notices in respect of licensed banks), although, like licensed banks, merchant banks are also expected to comply with guidelines, codes, practice notes and circulars. The regulation of merchant banks will shortly be consolidated under the BA as amendments to bring merchant banks within the ambit of the BA have been passed, although there is as yet no indication as to when those amendments will come into force.

It should be noted that licensed banks and merchant banks can also provide, inter alia, capital markets services and financial advisory services, which will be subject to separate regulatory frameworks set out in the Securities and Futures Act (Chapter 289 of Singapore) (SFA) and the Financial Advisers Act (Chapter 110 of Singapore) (FAA). While there are generally exemptions to the relevant licensing requirements, these entities may be required to comply with business conduct and other compliance requirements thereunder.

# 2. Authorisation

## 2.1 Licences and Application Process

### Types of Licences and Scope of Activities under Each

In order to conduct banking business in Singapore, an entity must hold a licence under the BA. Under the BA, the term "banking business" means the business of receiving money on current or deposit account, paying and collecting cheques drawn by or paid in by customers, and the making of advances to customers.

#### *BA licences*

The MAS generally grants banking licences to two broad categories of FIs: full banks and wholesale banks.

Full banks may undertake universal banking, and can provide all banking services permitted under the BA, including deposit taking and cheque services, as well as lending (which is separately regulated under the Moneylenders Act). While the full bank licence is available to both Singapore-incorporated banks and banks incorporated outside Singapore, foreign banks who operate as full banks have more limited privileges as to the number of branches and automated teller machines (ATMs) that they may operate. The MAS also has a Significantly Rooted Foreign Bank Framework in place, under which certain Qualifying Full Banks (QFB) that were awarded licences either pursuant to free trade agreements or during the initial liberalisation of the banking sector in 1999 have been granted a more extensive set of privileges (compared to foreign full banks). Amongst other things, QFBs are allowed to operate at more locations, to freely relocate sub-branches, to share their ATM networks with other foreign banks, and to provide debit services through an electronic funds transfer at point of sale network.

Wholesale banks (which may be incorporated in Singapore or otherwise) may conduct only the activities specified in the Guidelines for Operation of Wholesale Bank – these activities are the same as those permitted to be undertaken by full banks, except wholesale banks may not undertake Singapore dollar retail banking activities. Wholesale banks may operate an Asian Currency Unit (ACU) for the booking of its non-Singapore dollar operations.

#### *Merchant bank approval*

The scope of activities that a merchant bank (both incorporated in Singapore or otherwise) can conduct is set out in the Guidelines for Operation of Merchant Banks (Merchant Banks Guidelines); it may also operate an ACU if approved by the MAS. While some of its activities are similar to that of full banks and wholesale banks (for example, it can participate in lending activities), a merchant bank is not allowed to accept deposits or borrow money from the public, except from banks, finance companies, shareholders and companies controlled by shareholders, nor to raise monies by issuing promissory notes, commercial papers or certificates of deposits or by accepting or endorsing bills of exchange.

*Restriction on activities*

Aside from banking business, licensed banks and merchant banks are generally permitted to enter into any business the conduct of which is regulated or authorised by the MAS, such as capital markets services or financial advisory services. Licensed banks, however, are prohibited from carrying out non-financial businesses.

**Application Process and Admission Criteria**

An entity that intends to carry on banking business in Singapore must make an application in writing to the MAS.

*Full banks*

There is currently no prescribed form for an application for a banking licence to operate a full bank in Singapore – this is largely a function of the fact that applications for full banks are generally limited, and early discussion with the MAS is required prior to submitting any application.

*Wholesale/merchant banks*

Entities that intend to apply for a banking licence to operate a wholesale bank or be approved as a merchant bank in Singapore must submit the prescribed application form set out on the MAS' webpage (www.mas.gov.sg/regulation/Banking/Licensing-and-Authorisation-for-Banking-Business) to the MAS. The application must include the following:

- background information on the bank, including information on the shareholding structure of the applicant;
- financial indicators of the applicant on a global basis, and credit ratings;
- an overview of the applicant's business strategies/new project pipeline for its Singapore operations for the next three years;
- detailed plans for each business area of the Singapore office (eg, commercial banking, investment banking, asset management, etc);
- information on the banking system and supervisory framework in the applicant's home country;
- the original letter from the home country supervisory authority approving the establishment of the office in Singapore;
- an undertaking from the applicant to keep the MAS informed of any material adverse developments, including breaches of legal and prudential requirements;
- annual reports of the applicant for the last two years; and
- annual reports of the applicant's holding company or controlling shareholders for the latest financial year.

Prior to submitting a formal application, prospective applicants are encouraged to contact the Banking Department of the MAS to discuss its plans. Early engagement with the MAS would allow for the identification of any key issues that may be gating items for the purposes of the application. In assessing an application, the MAS takes the following factors (in addition to the ability to meet the minimum capital requirements) into consideration when assessing an application:

- the financial soundness, track record and reputation of the applicant, its parent company and major shareholders;
- the strength of home company supervision, including the willingness and ability of the home supervisory authority to co-operate with the MAS, and its cross-border co-operation framework;
- a well-thought out strategy for banking and financial services in Singapore, and sound business plans to ensure sustained economic viability; and
- robust risk management systems and processes that are commensurate with the applicant's size and proposed business.

The MAS has indicated that the processing time for a wholesale or merchant bank application would typically be three to four months, provided that the information submitted is to the MAS' satisfaction. The actual processing time would depend on the circumstances of each application.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

**Requirements Governing Change in Control**

*Singapore-incorporated banks*

A person must obtain prior written approval from the Minister in charge of the MAS (the Minister) in order to become the following, in respect of a Singapore-incorporated bank:

- a substantial shareholder – ie, a person who has an interest in voting shares where the total votes attached to those shares are not less than 5% of the total votes attached to all the voting shares in that Singapore-incorporated bank;
- a 12% controller, or a 20% controller – ie, a person who, either alone or together with associates, holds at least 12%, or 20%, of the issued shares of that bank or is in a position to control at least 12%, or 20%, of the voting power in that Singapore-incorporated bank; and

- an indirect controller – ie, any person (either alone or together with any other person, and irrespective of his shareholding or voting power in that Singapore-incorporated bank) whose directions, instructions or wishes the directors of that Singapore-incorporated bank are accustomed or obliged to act in accordance with, or who is able to determine the policy of that Singapore-incorporated bank.

In addition, Singapore-incorporated banks cannot be merged or consolidated with, or be taken over by, any entity without the Minister's prior written approval.

In considering whether to approve the application, the MAS must be satisfied of the following:

- that the substantial shareholder, controller or relevant entity is a fit and proper person in accordance with the Guidelines on Fit and Proper Criteria (Fit and Proper Criteria); and
- having regard to the likely influence of the substantial shareholder, controller or relevant entity, that the business of the Singapore-incorporated bank will continue to be conducted prudently and the provisions of the BA will continue to be complied with.

The Minister must also be satisfied that it is in the national interest to approve such an application.

In addition to the statutory requirements, the MAS may impose licensing conditions on Singapore-incorporated banks to obtain the approval of, or make notification to, the MAS of any changes or proposed changes in ownership or control of the bank.

#### *Foreign-incorporated banks*
Under the BA, there are no statutory requirements in respect of regulatory approval or notification for changes in the shareholding/control of foreign-incorporated banks. However, the MAS may impose licensing conditions on foreign banks to notify the MAS of any changes or proposed changes in ownership or control of the bank.

#### *Merchant banks*
Prior approval of the MAS must be obtained for the transfer or sale of shares or a change in the shareholders of a merchant bank.

### Nature of Regulatory Filings/Notifications
There is no prescribed form or process for the purposes of any of the above notifications or approval applications.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Requirements Specific to Singapore-Incorporated Banks
Singapore-incorporated banks are required to comply with corporate governance requirements set out in the Banking (Corporate Governance) Regulations 2005 (CG Regulations), and the Guidelines on Corporate Governance for Financial Holding Companies, Banks, Direct Insurers, Reinsurers and Captive Insurers which are Incorporated in Singapore (CG Guidelines).

#### *Board and committee compositions*
Under the CG Regulations, the majority of the board of a Singapore-incorporated bank must comprise independent directors (ie, a person who is independent from any substantial shareholder of, and any management and business relationship with, the Singapore-incorporated bank, and has not served on the board for a continuous period of nine years or longer).

Where the Singapore-incorporated bank is a subsidiary of another corporation incorporated or established outside Singapore, at least one-third of the board must be Singapore citizens or permanent residents; otherwise, a majority of the board must be Singapore citizens or permanent residents.

In general, Singapore-incorporated banks must also have a Nominating Committee, a Remuneration Committee, an Audit Committee and a Risk Management Committee, the composition of which is prescribed in the CG Regulations.

#### *CG Guidelines*
The CG Guidelines provide guidance on best practices in relation to board matters, remuneration matters, accountability and audit, shareholder rights and responsibilities, and oversight of related party transactions.

While not legally binding per se, Singapore-incorporated banks are expected to observe the CG Guidelines to the fullest extent possible, to disclose their corporate governance practices and to explain deviations from the CG Guidelines through annual reports (for a Singapore-listed Singapore-incorporated bank) or websites (for a Singapore-incorporated bank that is not listed in Singapore).

### Requirements Applicable to All Licensed Banks
In addition to the requirements listed above, both Singapore-incorporated banks and foreign banks are required to comply with the following:

- the Guidelines on Risk Management Practices – Board and Senior Management (Risk Management Guidelines), which highlight the corporate governance roles of the FI's Board

and senior management in ensuring a sound risk management culture and environment; and
- the Guidelines on Individual Accountability and Conduct (Accountability Guidelines), which set out measures FIs should put in place to promote the individual accountability of senior managers, strengthen oversight over material risk personnel, and reinforce standards of proper conduct among all employees. The Accountability Guidelines will come into effect on 10 September 2021.

## 4.2 Registration and Oversight of Senior Management

### Regulatory Approval and Requirements for Key Appointments

Licensed banks as well as merchant banks must obtain the MAS' prior approval for the appointment of their chief executive officers (CEOs), deputy CEOs and the head of treasury of their Singapore operations. In addition, a Singapore-incorporated licensed bank must obtain the MAS' prior approval for the appointment of all directors, the chairman of the Board, the chief financial officer, the chief risk officer, and the members of the Nominating Committee.

There is no prescribed application form for the approval of key persons.

In its assessment of the relevant individual, the MAS will have regard to whether the proposed appointee meets the Fit and Proper Criteria.

### Accountability Requirements

Licensed banks and merchant banks are also expected to achieve five accountability and conduct outcomes under the Accountability Guidelines, three of which relate specifically to senior managers:

- senior managers responsible for managing and conducting the FI's core functions are to be clearly identified;
- senior managers must be fit and proper for their roles and held responsible for the actions of their staff and the conduct of the business under their purview; and
- the licensed bank/merchant bank's governance framework supports senior managers' performance of their roles and responsibilities, with a clear and transparent management structure and reporting relationships.

Under the Accountability Guidelines, licensed/merchant banks will need to identify and define clearly the senior management who are responsible for functions that are core to the management of the FI's affairs. A list of core management functions is set out in the Accountability Guidelines, and includes the usual C-suite officers but also extends to business and support function heads, such as the head of business function, head of human resources, chief regulatory officer, head of internal audit, head of compliance, chief information officer, chief information security officer and chief data officer.

Licensed/merchant banks also need to (i) establish appropriate governance policies and processes to promote proper accountability and facilitate the senior managers' performance of their roles and responsibilities in an effective manner, and (ii) maintain accurate and comprehensive records of the roles and responsibilities of their senior managers and their overall management structure.

Unlike in other jurisdictions, the information, records and policies on or relating to senior management do not have to be formally submitted to the MAS. However, the MAS has indicated that it may review the effectiveness of an institution's governance frameworks as part of its ongoing supervision, including the relevant policies, systems and documentation, as well as senior management's understanding of their areas of responsibility. The MAS may take supervisory action against an FI that does not meet requirements.

FIs have until September 2021 to comply with the Accountability Guidelines.

## 4.3 Remuneration Requirements

### Remuneration Principles

For licensed banks and merchant banks, the Risk Management Guidelines provide that the board should oversee the design and operation of the institution's remuneration policies and ensure that they:

- are in line with the long-term strategic objectives, financial soundness and corporate values of the institution;
- do not give rise to conflicts between the objectives of the institution and the individual interests of directors and senior management; and
- do not create incentives for excessive risk-taking behaviour.

Singapore-incorporated licensed banks are subject to more specific requirements. In particular, the CG Regulations require that the remuneration committee recommends a remuneration framework for the directors and executive officers of the bank, which must, inter alia, be:

- aligned to the specific job functions undertaken by the executive officer;
- aligned with the risks that the bank undertakes in its business that are relevant to the executive officer's specific job function;

- sensitive to the time horizon of risks that the bank is exposed to, which includes ensuring that variable compensation payments shall not be finalised over short periods of time when risks are realised over long periods of time; and
- linked to the executive officer's personal performance, the performance of his job function as a whole and the overall performance of the bank.

The CG Guidelines further provide that the level and structure of remuneration should be aligned with the long-term interest and risk policies of the Singapore-incorporated licensed bank, and should be appropriate to attract, retain and motivate the directors to provide good stewardship of the bank, and the key management personnel to successfully manage the bank. Singapore-incorporated licensed banks are also expected to adopt the Principles for Sound Compensation Practices and Implementation Standards issued by the Financial Stability Board, which are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes.

In addition, Singapore-incorporated licensed banks are required to ensure that compensation practices and policies are not unduly linked to short-term accounting profit generation, but rather to longer-term capital preservation and the financial strength of the bank. In particular, MAS Notice 637 on Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore requires that Singapore-incorporated licensed banks must make public disclosure of key information relating to regulatory capital and risk exposures as well as an annual disclosure of remuneration policy, remuneration awarded during a financial year, special payments and deferred remuneration.

### Supervisory Approach

The MAS conducts thematic inspections on the incentive structures of banks. In 2018, the MAS assessed selected banks' governance over, and frameworks and policies for, performance evaluation, remuneration and consequence management, and whether these were aligned with the Principles.

The MAS has indicated that it expects the board and senior management of banks to ensure that remuneration frameworks and policies are implemented effectively, and that banks benchmark themselves against the desired outcomes set out in an information paper published in March 2019 entitled "Incentive Structures in the Banking Industry – Fostering Sound Behaviour and Conduct". The MAS has stated that it intends to continue engaging banks as part of its ongoing supervision, and will take relevant observations into account in its supervisory assessments of the banks.

# 5. AML/KYC

## 5.1 AML and CTF Requirements

As with all other persons in Singapore, licensed banks and merchant banks are subject to the Corruption, Drug Trafficking and Other Serious Crimes (Confiscation of Benefits) Act (Chapter 65A of Singapore), which criminalises the laundering of proceeds generated by criminal conduct and drug trafficking, and to the Terrorism (Suppression of Financing) Act (Chapter 325 of Singapore), which criminalises acts of financing terrorism.

In addition to these, licensed banks must comply with the anti-money laundering and countering financing of terrorism (AML/CFT) obligations specific to their licensing status. Banks are to comply with MAS Notice 626 Prevention of Money Laundering and Countering the Financing of Terrorism – Banks, while merchant banks must comply with a similar set of obligations under MAS Notice 1014 Prevention of Money Laundering and Countering the Financing of Terrorism – Merchant Banks (together, the MAS AML/CFT Notices).

Under the MAS AML/CFT Notices, banks must assess the overall AML/CFT risks they face at an enterprise-wide level, and take steps to effectively mitigate such risks. Banks are also required to comply with specific requirements concerning correspondent banking, wire transfers and record keeping.

When conducting customer due diligence, banks are also expected to identify and verify the identities of customers; where a customer is a non-individual, banks are expected to identify and verify its beneficial owner(s).

Banks must also monitor their business relations with customers on an ongoing basis, and must screen customers against relevant AML/CFT information sources and sanctions lists in the following scenarios:

- when the bank establishes business relations with the customer, and on an ongoing basis thereafter;
- when the bank undertakes any transaction of a value exceeding SGD20,000 for any customer who has not otherwise established business relations with it; or
- when the bank effects or receives any funds by domestic wire transfer, or by cross-border wire transfer that exceeds SGD1,500 for a customer who has not otherwise established business relations with it.

The MAS AML/CFT Notices also require banks to report suspicious transactions to the Suspicious Transaction Reporting Office (in the Commercial Affairs Department of the Singapore Police Force), and to implement appropriate internal policies, procedures and controls for meeting its obligations under the law.

MAS Notice 641 on Reporting of Suspicious Activities and Incidents of Fraud imposes an additional requirement on all licensed banks to report to the MAS any suspicious activities and incidents of fraud that are material to the safety, soundness or reputation of the bank. MAS Notice 1112 imposes the same additional requirement on all merchant banks.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

All full banks (regardless of jurisdiction of incorporation) are required to be members of the Deposit Insurance Scheme (the Scheme), which is established under the Deposit Insurance and Policy Owners' Protection Schemes Act (Chapter 77B of Singapore) to provide limited compensation to insured depositors under certain circumstances. The Scheme is administered by the Singapore Deposit Insurance Corporation Limited, and funded by premium contributions of all Scheme members.

All non-bank depositors (eg, individuals, partnerships, companies, etc) who place SGD deposits with Scheme members will be covered by the Scheme. The Scheme covers deposits in standard savings, current or fixed deposit accounts or amounts placed under the Central Provident Fund (CPF) Investment Scheme, the CPF Retirement Sum Scheme and the Supplementary Retirement Scheme.

SGD deposits in savings, fixed deposit and current accounts, and monies placed under the Supplementary Retirement Scheme, are insured for up to SGD75,000 in aggregate per depositor per Scheme member. Monies placed under the CPF Investment Scheme and CPF Retirement Sum Scheme are aggregated and separately insured up to SGD75,000. Trust and client accounts are insured up to SGD75,000 per account without aggregation.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

Banking secrecy is governed under section 47 of the BA, which broadly prohibits a licensed bank or its officers – including a director, secretary, employee, receiver or manager and liquidator – from disclosing customer information in any way to any other person except as permitted under the BA. These requirements also apply to merchant banks, with minimal modifications.

#### In-Scope Relationships and Information

The banking secrecy requirements apply to "customer information", where the term customer refers to a customer of the bank (including central banks and the MAS) but excludes any other bank. Information obtained from a customer during the banking relationship must not be disclosed, and includes the following:

- any information relating to, or any particulars of, an account of a customer of a bank, whether the account is in respect of a loan, investment or any other type of transaction; and
- any information relating to any deposit of a bank, funds of a customer under management by the bank, or any safe deposit box maintained by, or any safe custody arrangements made by, a customer with the bank.

Information that is not referable to any identifiable customer or group of identifiable named customers is not caught under section 47 of the BA.

#### Principal Exceptions Permitting Disclosure

The BA sets out, across two parts, an exhaustive list of circumstances where the disclosure of customer information may be permitted. The recipient of the customer information may, in certain circumstances, be prohibited from onward disclosure of the customer information.

Subject to compliance with specific conditions, customer information may be disclosed by the licensed bank or merchant bank where disclosure is:

- permitted in writing by the customer;
- solely in connection with the bankruptcy or winding up of a customer who is an individual or a body corporate, respectively, to be made to all persons to whom the disclosure is required for such purposes;
- necessary for compliance with a garnishee order served on the bank attaching moneys in the account of the customer, to be made to all persons to whom the disclosure is required to be made under such order;
- necessary for compliance with a request made by a parent supervisory authority, where the bank is a foreign bank or a foreign-owned Singapore-incorporated bank;
- solely in connection with the conduct of an internal audit of the bank or the performance of risk management, to be made to the parent bank or any related corporation of the bank designated in writing by the parent bank;
- solely in connection with the performance of operational functions of the bank where such operational functions have been outsourced, to be made to any person (including the head office of the bank or any branch thereof outside Singapore) that is engaged by the bank to perform the outsourced

function – in this regard, licensed banks must comply with the conditions set out under MAS Notice 634 on Banking Secrecy – Conditions for Outsourcing, and merchant banks must comply with the same under MAS Notice 1108; and
- strictly necessary for the assessment of the credit-worthiness of the customer in connection with a bona fide commercial transaction or a prospective commercial transaction, to be made to any other licensed bank or merchant bank in Singapore, and such disclosure must be limited to information of a general nature and not related to the details of the customer's account with the bank.

### Consequences of Breach
An individual who breaches section 47 of the BA is liable upon conviction to a fine not exceeding SGD125,000, or to imprisonment for a term not exceeding three years, or to both. In the case of body corporates that breach the prohibition, the offence is punishable with a fine not exceeding SGD250,000.

## 8. Prudential Regime

### 8.1 Capital, Liquidity and Related Risk Control Requirements

#### Minimum Capital Requirements
The minimum paid-up capital for a Singapore-incorporated bank is SGD1.5 billion, which is reduced to SGD100 million for a Singapore-incorporated bank with a wholesale banking licence, or a Singapore-incorporated bank that is a subsidiary of another Singapore-incorporated bank. A Singapore-incorporated merchant bank must have a paid-up capital of at least SGD15 million.

A foreign bank operating through a branch must ensure that its head office capital funds are not less than the equivalent of SGD200 million. A merchant bank whose head office is situated outside Singapore is required to maintain head office funds of at least SGD15 million at all times.

#### Capital Adequacy Requirements
Singapore-incorporated licensed banks are subject to the capital adequacy requirements set out in MAS Notice 637 on Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore (MAS Notice 637), which incorporates the Basel III standards.

Under MAS Notice 637, capital adequacy ratio (CAR) requirements are imposed at the following two levels:

- bank standalone level (Solo Level) CAR requirements, which measure the capital adequacy of a Singapore-incorporated bank based on its standalone capital strength and risk profile; and
- consolidated level (Group Level) CAR requirements, which measure the capital adequacy of a Singapore-incorporated bank based on its capital strength and risk profile after consolidating the assets and liabilities of its banking group entities, taking into account exclusions of certain banking group entities or adjustments for securitisation as provided under MAS Notice 637.

Singapore-incorporated licensed banks designated as domestic systemically important banks (D-SIBs) must maintain the following CARs at all times, which are higher than the Basel III minimum requirements:

- a minimum common equity Tier 1 CAR of 6.5%;
- a minimum Tier 1 CAR of 8%; and
- a minimum total CAR of 10%.

Singapore-incorporated licensed banks that have not been designated as D-SIBs are only required to maintain the Basel III minimum CAR requirements.

In accordance with the Basel Committee's requirements, Singapore-incorporated banks are required to maintain a capital conservation buffer of 2.5% above the minimum CAR.

Separately, Singapore-incorporated merchant banks are subject to the capital adequacy requirements set out in MAS Notice 1111 on Risk Based Capital Adequacy Requirements for Merchant Banks incorporated in Singapore.

#### Leverage Ratio
In accordance with the Basel III leverage ratio framework, MAS Notice 637 imposes a minimum leverage ratio of 3% on Singapore-incorporated banks at the following levels:

- the Solo Level, which measures the leverage ratio of a Singapore-incorporated bank based on its standalone capital strength; and
- the Group Level, which measures the leverage ratio of a Singapore-incorporated bank based on its capital strength after consolidating the assets and liabilities of its banking group entities, taking into account exclusions of certain banking group entities or adjustments for securitisation as provided under MAS Notice 637.

Merchant banks are not currently subject to similar leverage ratios.

**Liquidity Requirements**

***Minimum liquid assets (MLA) and liquidity coverage ratio (LCR)***

Section 38 of the BA and MAS Notice 649 on Minimum Liquid Assets and Liquidity Coverage Ratio (MAS Notice 649) set out the MLA and LCR frameworks that are applicable to licensed banks (whether Singapore-incorporated or foreign).

Singapore-incorporated banks that are D-SIBs or notified by the MAS to be internationally active banks due to significant banking operations overseas (internationally active banks) are required to comply with both the MLA framework and the LCR framework, while other licensed banks have the option of complying with the MLA framework or the LCR framework.

Under the MLA framework, all licensed banks must hold at least 16% of the value of their qualifying liabilities denominated in all currencies, in liquid assets denominated in any currency, and a minimum 16% of the value of its SGD qualifying liabilities in SGD liquid assets. At least 50% of the liquid assets held by the licensed bank must be held in Tier 1 liquid assets (as defined under MAS Notice 649).

Under the LCR framework, which implements the Basel III LCR rules, banks are required to hold sufficient high-quality liquid assets to match their total net cash outflows over a 30-day period. Internationally active banks and Singapore-incorporated D-SIBs must maintain a Singapore dollar LCR of at least 100% and an all-currency LCR of 100% at all times. Foreign banks that are D-SIBs, or other licensed banks that choose to comply with the LCR framework, must maintain at all times a Singapore dollar LCR of at least 100% and an all-currency LCR of 100% if the bank's head office or parent bank is incorporated in Singapore or 50% if the bank's head office or parent bank is incorporated outside Singapore.

In respect of LCR, Singapore-incorporated banks that are D-SIBs or internationally active banks must additionally disclose qualitative and quantitative information about their LCR pursuant to MAS Notice 651 on Liquidity Coverage Ratio Disclosure.

MAS Notice 1015 on Minimum Liquid Assets and Liquidity Coverage Ratio sets out the MLA and LCR frameworks in respect of merchant banks (regardless of the jurisdiction of incorporation).

***Net Stable Funding Ratio (NSFR)***

Under section 10C of the BA, the MAS may require any licensed bank to maintain a minimum stable funding ratio and/or a minimum amount of stable funds. In this regard, MAS Notice 652 on Net Stable Funding Ratio (MAS Notice 652) imposes the requirement on internationally active banks and D-SIBs incorporated and headquartered in Singapore to maintain an all-currency NSFR of at least 100% on a consolidated group level (after excluding certain banking group entities). D-SIBs whose head office or parent bank is incorporated outside Singapore are required to maintain a minimum all-currency NSFR of 50% at the entity level, or, if the MAS has so approved, at the country-level group basis. These requirements are aligned with the Basel Committee's standards on NSFR.

MAS Notice 653 on Net Stable Funding Ratio (MAS Notice 653) further imposes an obligation on internationally active banks and D-SIBs incorporated and headquartered in Singapore to disclose certain qualitative and quantitative information about their NSFR.

***Minimum cash balance***

Section 39 of the BA and MAS Notice 758 on Minimum Cash Balance set out the requirement for licensed banks to maintain, during a maintenance period, an aggregate minimum cash balance with the MAS of at least an average of 3% of its average qualifying liabilities as defined thereunder.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

**Resolution Regime**

The resolution regime for licensed banks and merchant banks is set out primarily in Part IVB of the MAS Act, and in the Monetary Authority of Singapore (Resolution of Financial Institutions) Regulations 2018. The resolution regime incorporates the Key Attributes of Effective Resolution Regimes for Financial Institutions formulated by the Financial Stability Board.

Banks which the MAS (in its capacity as the resolution authority) considers to be systemically important are directed to prepare and implement a recovery and resolution plan in accordance with the MAS Notice 654 on Recovery and Resolution Planning (MAS Notice 654) and the Guidelines to MAS Notice 654 on Recovery and Resolution Planning.

In addition, the MAS may exercise the following resolution powers in respect of a distressed bank:

- direct the transfer of business or shares to a private sector acquirer;
- compel the transfer of business to a bridge entity;
- compel the transfer of assets to an asset management company set up by the MAS;
- in respect of a Singapore-incorporated bank, bail-in the instruments of ownership and liabilities of that bank;

- temporarily suspend termination rights of counterparties in a contract with that bank; and
- apply to the High Court of Singapore to wind up and liquidate a distressed bank based on grounds provided under the MAS Act (in addition to those in the Insolvency, Restructuring and Dissolution Act 2018 (No. 40 of 2018) (IRDA)).

The MAS has indicated that it may use the aforementioned resolution tools singly or in combination, depending on the situation and to best meet its resolution objectives. However, the MAS' preference is to seek private sector solutions before exploring resolution strategies that involve government or public sector support.

The MAS is also empowered to share information with a foreign resolution authority in certain circumstances, and to recognise a foreign resolution in whole or in part (as the case may be).

### General Insolvency Framework
Notwithstanding the foregoing, it should be noted that the MAS does not aim to prevent any bank from failing, and the general corporate insolvency framework would apply where the MAS refrains from exercising its resolution powers. The general legislative framework for general corporate insolvency is set out in the IRDA, and is applicable to banks in Singapore. In addition, the BA (and the MAS Act) empowers the MAS – in its capacity as the supervisory and regulatory authority of banks (and merchant banks) – to take the following actions against a licensed bank that has become insolvent, or is likely to do so:

- direct such bank to take or refrain from taking any action it considers necessary;
- appoint a statutory adviser to advise on the proper management of the bank's business; or
- assume control of and manage the bank's business via an appointed statutory manager or otherwise.

In the case of a foreign-incorporated licensed bank or merchant bank, the MAS' actions will only relate to that bank's business carried on in, or managed from, Singapore, and its properties in Singapore.

In the event of the winding-up of a bank in Singapore, the liquidator must first set-off a depositor's liabilities to the bank against any deposit of the depositor placed with the bank (other than with the ACU). The BA further prescribes the order of priority of a bank's liabilities in Singapore for its winding-up – in summary, premium contributions due and payable in respect of the Scheme as well as deposit liabilities will have priority over other claims on the relevant bank.

# 10. Horizon Scanning

## 10.1 Regulatory Developments
The following regulatory developments have been discussed in further detail in the context of relevant sections above:

- Digital banking – as part of its initiative to liberalise Singapore's banking sector, the MAS has issued two digital full bank and two digital wholesale bank licences. The MAS received 21 applications for digital bank licences.
- Regulating merchant banks under the BA – with effect from 1 October 2020, banks and merchant banks will no longer need to maintain two separate accounting units for the domestic banking unit and the ACU. In relation to this, the MAS will be consolidating the regulation of merchant banks under the BA. However, as mentioned above, the MAS has yet to announce when the new regulatory regime will come into force.
- Accountability guidelines – the Accountability Guidelines, which were issued on 10 September 2020, will become effective on 10 September 2021.

Separately, the MAS has consulted on the following proposals in 2020, which may impact banks in Singapore in the near future.

### New Omnibus Act for the Financial Sector
The MAS is proposing to introduce a new omnibus Act for the financial sector, which will incorporate the existing provisions currently in the MAS Act that relate to the MAS' regulatory oversight of different FIs across the financial sector. In particular, these provisions pertain to the prevention of money laundering and terrorism financing, and the control and resolution of FIs.

Under the new Act, the MAS intends to introduce a harmonised and expanded power to issue prohibition orders across all categories of FIs under the MAS' regulatory oversight. Presently, the MAS may only issue prohibition orders under the SFA, the FAA and and the Insurance Act (Chapter 142 of Singapore) (IA), and such prohibition orders only prohibit the subject from taking up specified positions (ie, directorship, substantial shareholding, management) and conducting certain activities that are regulated under the SFA, FAA and IA. Under the proposal, the MAS would be able to issue prohibition orders against unsuitable persons from the BA, amongst other things. It would also be able to prohibit the individual from undertaking functions in an FI (including a bank), such as the handling of funds, risk-taking, risk management and control, and critical system administration.

In addition, the MAS' powers to impose requirements on technology risk management (such as requirements on the resilience of critical systems, incident reporting and cyberhygiene) will be harmonised under the new Act. The MAS also intends to introduce a power to issue directions to or make regulations concerning any FI or class of FIs for the management of technology risks, including cybersecurity risks, the safe and sound use of technology to deliver financial services, and safe and sound use of technology to protect data. In addition, the maximum penalties imposed for breaches of these requirements will be increased to SDG1 million to better commensurate with the potential severity of a disruption to essential financial services and the potential impact on FIs' customers.

The public consultation on the new omnibus Act closed on 20 August 2020, but the MAS has yet to issue its comments on the responses received.

**Environmental Risk Management**

The MAS is proposing to introduce Guidelines on Environmental Risk Management to enhance banks' resilience to and management of environmental risk, by setting out sound practices in relation to the banks' governance, risk management and disclosure of environmental risk.

These guidelines will apply to licensed banks and merchant banks, in respect of such banks' extension of credit to corporate customers and underwriting for capital market transactions. The banks should also apply the guidelines to other activities that expose them to material environmental risk.

**Notice on Identity Verification**

The MAS proposes to mandate the types of information FIs (including banks) must use to verify the identity of an individual for non-face-to-face contact. The objective is to address the risk of impersonation fraud arising from the theft and misuse of an individual's personal particulars.

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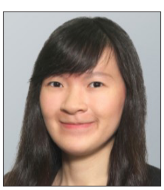

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# SOUTH KOREA

## Trends and Developments


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### Enactment of the Financial Consumer Protection Act

The Financial Consumer Protection Act (FCPA) is scheduled to take effect on 25 March 2021, and aims to combine provisions governing the protection of financial consumers that are scattered across different statutes and regulations into a single statute in order to enable the effective administration of the relevant provisions. For this purpose, the FCPA reclassifies financial products and sales channels so that the same regulations apply to financial products that have the same functions. Specifically, financial products are reclassified into:

- deposit products;
- investment products;
- insurance products; and
- loan products under the FCPA.

Overall, the FCPA will apply stricter consumer protection standards than the existing rules and will introduce new provisions relating to consumer rights, such as the right of a consumer to terminate contracts that violate the Sales Principles (as defined below), a prohibition on financial companies (including banks) abandoning dispute resolution procedures, and the shifting of the burden of proof to financial companies in lawsuits concerning a violation of the "duty to explain".

Banks in Korea that offer financial products regulated under the FCPA (including deposit, loan and credit card products) will need to comply with stricter consumer protection measures adopted under the FCPA.

#### *Application of the Sales Principles and the right to withdraw from or terminate financial contracts*

The existing rules apply the following six basic Sales Principles to the sale of certain financial products:

- the principle of suitability;
- the principle of adequacy;
- the "duty to explain";
- the prohibition on unfair practices;
- the prohibition on misleading or unsolicited recommendations; and
- the prohibition on false or exaggerated advertisements.

The FCPA will expand the application of these Sales Principles to more categories of financial products. Specifically, the principle of suitability, which prohibits financial companies from offering financial products that are not "suitable" based on the consumer's net worth and financial transaction experience, will apply to all financial products (Article 17). The principle of adequacy, which requires financial companies to inform a consumer when financial products sought to be purchased by such customer are not suitable based on the consumer's net worth, will apply to all financial products except for deposit products (Article 18). The "duty to explain", the prohibition on unfair practices, the prohibition on misleading or unsolicited recommendations and the prohibition on false or exaggerated advertisements will apply to all financial products.

The FCPA will also grant termination rights pursuant to which consumers will be able to unilaterally terminate a contract for a financial product if the seller has violated the Sales Principles without a reasonable excuse (Article 47). The draft Enforcement Decree to the FCPA, which was announced on 28 October 2020, allows such termination rights to be exercised either within five years of the date of the relevant financial contract or within one year of the date on which the financial consumer becomes aware of the violation, whichever is earlier. A seller who has violated the Sales Principles without a reasonable excuse will not be entitled to receive any reimbursement of expenses in connection with the unilateral termination of the relevant financial contract by the consumer.

In addition, the FCPA gives consumers the right to withdraw a subscription of financial products (other than deposit products) during a certain cooling-off period. Consumers will be able to require a financial company to return any amounts paid to it in connection with a subscription if such subscription is withdrawn during the cooling-off period. The cooling-off period for investment products is seven days from the date on which the relevant financial contract was entered into or the date on which the contract documents were delivered to the consumer. This period is extended to 14 days for loan products and 15 days for insurance products (Article 46).

### *Further enhanced consumer protection measures*

In addition to the above mentioned withdrawal and termination rights, the FCPA will also introduce a number of new ex-post consumer protection measures, including a prohibition on financial companies abandoning dispute resolution procedures that are in progress. Specifically, financial companies will not be permitted to commence legal proceedings with respect to disputes regarding claims that do not exceed KRW20 million in amount and are in mediation proceedings; if legal proceedings are pending in court concurrently with dispute resolution procedures, the court will be entitled to suspend the legal proceedings until the dispute resolution procedures have been concluded (Articles 41 and 42). With respect to any damage or loss resulting from a breach of the "duty to explain", the FCPA will shift the burden of proof to financial companies so that, in the event of a lawsuit concerning a breach of the "duty to explain", financial companies will be required to prove that the breach does not constitute intentional misconduct or negligence on the company's part (Article 44).

Further customer protection measures set out in the FCPA include the requirement on sellers of financial products to establish internal control standards for consumer protection (Article 16) and the right of regulators to restrict sales of a financial product that is expected to cause significant damage to consumers (Article 49). The obligation of sellers to establish internal control standards under the FCPA is separate from the obligation to maintain internal control standards under the Act on Corporate Governance of Financial Companies. The FCPA will also impose stricter penalties on non-compliant financial companies by increasing the threshold for administrative fines and criminal penalties (Articles 67 and 69) and allowing the imposition of punitive fines of up to 50% of the offender's revenues in the case of a major breach of the Sales Principles (Article 57).

Financial companies are advised to pay close attention to the heightened consumer protection measures in the FCPA and to implement appropriate policies and procedures in their sales and customer support practices.

## Amendments to the Three Major Data Laws and Introduction of the My Data Business

Earlier this year, the 20th National Assembly passed amendments to the following three major data privacy laws (the so-called Three Major Data Laws) to expand the range of information available for use by individuals and businesses:

- the Personal Information Protection Act (PIPA);
- the Act on the Promotion of Information and Communications Network Utilisation and Information Protection (the Network Act); and
- the Act on the Use and Protection of Credit Information (the Credit Information Act).

These amendments became effective on 5 August 2020. The main objective of these amendments is to enable more use of data. Banks will need to assess and monitor how the Three Major Data Laws will impact the ways in which they manage and use personal information in their business operations.

### *Main features of the amendments to the Three Major Data Laws*

The PIPA newly defines "pseudonymised data" as personal information that has been partially deleted or partially or totally substituted, such that the information can no longer be used to identify an individual without being combined with additional information (pseudonymisation). The PIPA allows a person or entity who determines the purposes and means of personal data processing (a Data Controller) to process pseudonymised data without the data subject's consent for purposes such as statistical (data) preparation, scientific research and the preservation of public records. While the legal basis for businesses to use pseudonymised data has been established, it will be necessary to monitor the regulatory interpretation of this provision, particularly as to whether the use of pseudonymised data will be allowed for commercial purposes.

Under the Presidential Decree to the amended PIPA, a Data Controller may use or transfer personal data without the consent of the data subject in the following scenarios:

- if the use is reasonably related to the initial purpose of the collection;
- if the use will not cause any harm or loss to the data subject; and
- if security measures have been taken, such as encryption.

Prior to the amendment, Data Controllers could not collect, use or provide personal data beyond the scope for which the data subject had given his/her consent. Following the amendment, a Data Controller can process personal data that it already possesses without the data subject's consent, so long as the requirements set forth in the Presidential Decree are met.

While the previous Network Act required a data subject's consent for delegating the processing of their personal data to a third party pre-amendment, consent is not required for delegation under the amended regulations. Also, user consent will not be required for the delegation of the processing or storage of personal data to an overseas entity, if the online service provider discloses certain statutorily specified information on the overseas delegation to the users.

In order to support an individual data subject's management of its credit information, the amended Credit Information Act introduces a new business category, the "My Data" business. My Data business operators will collect and combine a data subject's credit information in accordance with methods prescribed by the Credit Information Act and related regulations. The My Data business model grants data subjects the right to data portability, as operators are required to transmit the combined credit information of a data subject to persons designated by the data subject, including the data subject itself, other My Data business operators, financial institutions and credit agencies.

***Government-led My Data business***

Korea's financial industry is moving towards greater innovation, based on various applications of big data from customers. With the implementation of the amendments to the Three Major Data Laws, financial institutions such as banks now have more flexibility in their use of customers' information to create and improve their financial services. The My Data business is one such service.

Under the My Data business plan, financial institutions provide customers' personal information to a third party approved by the Government as a My Data business operator. Such operator then compiles customers' information, allowing customers to enjoy a streamlined service where they can browse all of their financial information in one glance using the My Data business operator's website or mobile app. The introduction of the My Data business will allow customers to have greater control over their personal data, while allowing operators to analyse customer data and suggest the most suitable financial products to their customers.

In order to operate a My Data business, one must first obtain a licence from the Financial Services Commission. To obtain such a licence, several requirements must be met, including minimum capital requirements, investor requirements and feasibility business plan requirements, and the operator must also possess the necessary equipment. A large number of financial institutions, including banks, have already applied for a My Data business licence with the expectation that the My Data business will enable financial businesses to reach into other industries by utilising elements from other industries, and to resolve customer pain points and develop tailor-made financial products through an enhanced understanding of customer needs. The FSC is currently in the process of reviewing applications for the My Data business licence, with the final results of such review expected to be released in early 2021.

***Designation of the Personal Information Protection Commission as the central data privacy regulatory authority***

The amended PIPA designated the Personal Information Protection Commission (PIPC) as the central administrative agency for data privacy regulation, and transferred the data privacy regulatory functions of the Ministry of the Interior and Safety and the Korea Communications Commission to it. As such, PIPC will now be responsible for the enforcement of privacy regulations, which was previously spread among the related authorities.

The establishment of PIPC as the central administrative data regulatory agency will enable the Government to effectively negotiate with the European Commission in relation to an "adequacy decision" under the EU's General Data Protection Regulation. It is currently expected that Korea will be granted an adequacy decision by the European Commission, which will mean that Korea is deemed to have adequate personal information protection measures corresponding to the EU standards. In turn, such adequacy decision will allow for an unimpeded flow (or transfer) of personal data between the European Union and Korea.

**Proposed Expansion of Class Action Law and Punitive Damages in Commercial Law**

The Ministry of Justice has recently proposed legislation that would expand the scope of the country's existing class action law and awards of punitive damages. The proposed changes purportedly aim to provide a legal remedy for collective harm to the Korean public, and are likely to have a significant impact on the business community if passed. Currently, class action suits are only available for securities-related cases, but the proposed act (Class Action Act) would allow litigants to contest their cases as a class action in all areas of the law (ie, expanded to all incidents with more than 50 victims). Consequently, all companies – including banks that are organised as a company – could now find themselves facing class action lawsuits for any alleged wrongdoing in Korea.

To complement the proposed Class Action Act, the proposed changes to the Commercial Act (Amendment to the Commercial Act) introduce punitive damages in all commercial causes of action that will be applicable to "merchants", which are defined as "companies or owners operating as a business". Currently, punitive damages are only available under certain statutes, such as the Products Liability Act or the PIPA, and, most recently, under the Patent Act for wilful infringement. The Amendment to the Commercial Act will allow claimants to collect punitive damages of up to five times the damages sustained from a company's or business owner's intentional or grossly negligent conduct.

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The scope of the law's applicability of punitive damages is consistent with the Korean government's policy reasoning to punish and deter incidents that harm society in the pursuit of economic gain. Recent examples of such incidents include the controversial humidifier steriliser case, the automobile emissions scandal, the scandal involving certain private equity funds, the proliferation of fake news and massive human disasters that have resulted from violations of safety standards. Accordingly, banks (along with other financial institutions) would be subject to the proposed law and will need to take the risk of class action into account when establishing compliance guidelines for dealing in various financial products.

While these two anticipated bills are still proposals, the Korean National Assembly (the nation's highest legislative body) is supportive of these efforts. The potential ramifications of the proposed Class Action Act require careful consideration by businesses, as the act in its current proposal would allow claimants to bring action against businesses for events that occurred prior to the effective date of the law. Thus, causes of action that occurred prior to the passing of the legislation may still be subject to class action lawsuits if the statute of limitations has not expired. Unlike the Class Action Act, the Amendment to the Commercial Act is not retroactive, but will be applied prospectively after the bill passes.

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# SPAIN


## Law and Practice

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## Contents

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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Basic Framework

The main regulatory framework of the Spanish banking system is composed of the following regulations:

- Law 10/2014, of 26 June 2014, involving the management, supervision and solvency of credit institutions – incorporates Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, known as the Capital Requirements Directive (CRD IV) into the framework;
- Royal Decree 84/2015, of 13 February, implementing Law 10/2014;
- Regulation (EU) No 575/2013, of the European Parliament and of the Council of 26th June 2013, on the prudential requirements of credit institutions and investment firms, commonly known as the Capital Requirements Regulation (CRR);
- Bank of Spain Circular 2/2014 of January 31st, to credit institutions, on the exercise of various regulatory options contained in the CRR ("Circular 2/2014"); and
- Bank of Spain Circular 2/2016 of February 2nd, to credit institutions, on supervision and solvency, which completes the adaptation of the Spanish legal system to CRD IV.

### Bank of Spain Circulars

Additionally, credit institutions must consider the following local regulations:

- Bank of Spain Circular 4/2020 of 26th 26, on the advertising of banking products and services;
- Bank of Spain Circulars 2/2020 and 3/2020 of 11th June, to credit institutions, on public and confidential financial reporting standards and model financial statements;
- Bank of Spain Circular 1/2019 of January 30th, which modifies Circular 8/2015 of December 18th, to the entities and branches attached to the Deposit Guarantee Fund of Credit Institutions, on information to determine the basis for calculating the contributions to the Deposit Guarantee Fund of Credit Institutions; and
- Bank of Spain Circular 5/2017 of December 22nd, to credit institutions and payment service providers, on transparency in banking services and accountability in lending.

In addition to this framework, banks are affected by existing regulations in other areas, such as:

- sustainable finance (environmental, social and governance, or ESG);
- payment services, requiring strong customer authentication and common and secure open standards of communication, payment account switching and the accessing of payment accounts with basic features;
- mortgages and loans; and
- anti-money laundering (AML) and counter-terrorist financing.

### Supervisory Structure

In Europe, the European Central Bank (ECB), together with the national central banks (NCBs), comprises the European System of Central Banks (ESCB). All eurozone states participate in the Single Supervisory Mechanism (SSM), which promotes European financial stability.

The ECB is responsible for the prudential supervision of credit institutions as established under Regulation (EU) No 1024/2013. It supervises all EU Member States, regardless of whether they are in the eurozone.

The ECB carries out certain tasks for prudential supervisory purposes, including:

- granting and withdrawing authorisations;
- assessing notifications of the acquisition and disposal of qualifying holdings in credit institutions (excluding bank resolutions);
- performing supervisory reviews in conjunction with the European Banking Authority; or
- ensuring compliance with governance arrangements.

The Bank of Spain is part of the ESCB. Under the Spanish National Competent Authority, it is also conferred upon with supervisory tasks, such as:

- receiving notifications in relation to the right of establishment and the free provision of services;
- supervising credit institutions of third countries, establishing a branch or providing cross-border services within the European Union; and
- carrying out day-to-day verifications of credit institutions.

# 2. Authorisation

## 2.1 Licences and Application Process

### Types of Licenses, Activities, and Services Covered

The body responsible for authorising the creation of a credit institution in Spain is the European Central Bank, at the proposal of the Bank of Spain.

The following credit institutions exist in Spain:

- banks;
- savings banks;
- credit co-operatives; and
- the Official Credit Institute (*Instituto de Crédito Oficial*, ICO).

Credit institutions are authorised companies whose activity consists of:

- receiving deposits or other reimbursable funds from the public; and
- granting loans.

The banking licence is the most complete and broad licence that a financial institution can obtain in Spain. It generally enables an institution to provide every financial service included under Spanish regulations. Predominant examples are:

- banking services;
- payment services; and
- investment services.

#### Main Conditions for Authorisation

The requirements to obtain authorisation as a credit institution include:

- incorporation of the company for an indefinite period of time;
- securing an initial company share capital of no less than EUR18 million;
- limiting the scope of its corporate purpose contained in the articles of association, according to banking regulations;
- shareholders owning qualifying holdings must be deemed suitable;
- no special advantages or compensation are to be reserved for the founders;
- a board of directors consisting of at least five members: members of the board of directors, managing directors, similar officers, persons responsible for key internal control activities and other key positions, who must comply with suitability requirements;
- having appropriate administrative and accounting structures, in addition to adequate internal control procedures;
- having registered offices, effective management and administration in Spain; and
- having the appropriate procedures and internal control and communication bodies necessary to prevent money laundering and terrorist financing under the terms established in the relevant legislation.

#### Authorisation Process

The Bank of Spain will submit to the ECB a proposal for authorisation to exercise the activity of a credit institution, following a report by the Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (the Spanish Financial Intelligence Unit, SEPBLAC), the National Securities Market Commission (CNMV), and the Directorate General of Insurance and Pension Funds (DGSFP).

The application for authorisation must be resolved within six months of its receipt by the Bank of Spain, or when the required documentation is complete and, in any event, within 12 months of its receipt. If the application is not resolved within this period, it is understood to have been rejected.

#### Other Relevant Information

The Bank of Spain has transferred the direct supervision of significant credit institutions to the SSM, but retains that of less significant institutions, on which the SSM exercises indirect supervisory functions. It must be said that even in those cases in which the SSM is directly responsible for supervision, the Bank of Spain participates actively in the supervision of Spanish institutions, and in the supervision of the institutions of other SSM Member States.

The supervision of an institution's compliance with the rules of conduct and customer protection will vary depending on the services the institution provides. The Bank of Spain will monitor compliance with the banking regulations; the CNMV will monitor stock market regulations; SEPBLAC, the regulations for the prevention of money laundering and terrorist financing; and the DGSFP will monitor the insurance regulations and the distribution of insurance products.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

Any legal or natural person, acting independently or with others, that has resolved to purchase or increase, directly or indirectly, a qualifying holding in a Spanish credit institution must notify the Bank of Spain of their decision in advance. This is provided that the percentage of voting rights or capital held is equal to or greater than 20%, 30%, or 50%, and/or that, by virtue of the acquisition, they will come to control the credit institution.

#### Requirements of the Notification

The above notification must include mention of the below.

Of the potential acquirer, the following must be stated:

- its identity, its shareholding structure, and the composition of their managing bodies; and
- its professional and business standing (comprised of the detailed structure of any group of companies to which it belongs; its financial situation and that of any group to which it belongs; any relations, financial or otherwise, between the potential acquirer and the acquired entity and its group; and previous assessments by international AML bodies, in the case of non-EU potential acquirers).

Of the proposed acquisition:

- the identity of the organisation of which a qualifying holding is to be acquired;
- the purpose of the acquisition;
- the amount that is to be acquired, and the manner and place in which the acquisition will be carried out;
- the effects of the acquisition on the capital and voting rights, before and after the proposed acquisition;
- the existence of express or tacit concerted action with third parties relevant to the proposed transaction;
- prior agreements between other shareholders and the organisation of which a qualifying holding is going to be acquired;
- the financing of the acquisition – origin and availability of financial resources used for the acquisition, and entities through which they will be channelled;
- the shareholdings that cause a change in the entity's control and/or the business plan, including information on the strategic development of the acquisition, the financial statements, and other forecasts; and
- the main modifications the potential acquirer intends to make to the entity of which it is going to acquire a qualifying holding. This includes the acquisition's impact on corporate governance, structuring, the resources available to the internal oversight bodies, and AML/CTF procedures.

#### Authorisation Process

The Bank of Spain will evaluate the proposed acquisition of qualifying shareholdings, and will then submit the decision on the proposed acquisition to the ECB for it to be approved or opposed.

If deemed necessary, the Bank of Spain may request additional information from the potential acquirer, to evaluate their proposed acquisition.

In its assessment, the Bank of Spain will request a report from the Spanish AML/CTF authority (SEPBLAC), which includes its complete assessment of the transaction.

In the event that the potential acquirer is a resident of another EU Member State, the Bank of Spain may contact the competent authority in that country to carry out further verifications.

The decision to approve/oppose the transaction must be made within 60 business days of the Bank of Spain's acknowledged receipt of the application. Otherwise, it will be understood that there is no opposition to the acquisition from the Bank of Spain.

#### Other Requirements

In addition to the authorisation process detailed above, any person who has acquired, directly or indirectly, a holding in a credit institution in such a way that the percentage held is equal to or greater than 5% must immediately inform the Bank of Spain and the relevant credit institution in writing.

## 4. Supervision

### 4.1 Corporate Governance Requirements

The corporate governance requirements applicable to banks are increasingly demanding. The regulatory authority stresses the importance of the following:

- the knowledge and experience of board members required to perform their duties (considering the changing nature of financial regulation and the way in which banking services are currently provided);
- sufficient time commitment by the board members to perform their duties;
- well-defined, transparent, and coherent lines of responsibility;
- effective procedures for the identification, management, control and communication of risks;
- adequate internal control mechanisms; and
- remuneration policies and practices that are consistent with and promote appropriate and effective risk management.

Recently in Spain, the CNMV has reiterated the need for anti-corruption mechanisms involving top management and the board of directors.

### 4.2 Registration and Oversight of Senior Management

#### Registration of Senior Management

Regardless of their registration with the Spanish Commercial Registry, the exercise of Senior Management functions at banks requires prior registration in the Senior Management Registry of the Bank of Spain and the ECB.

For that reason, credit institutions must notify the Bank of Spain and the ECB of any new members and provide assurance that they:

- meet the suitability requirements; and
- are not subject to any of the limitations or incompatibilities established in the applicable regulations.

### Suitability Requirements

Credit institutions must have a board of directors composed of persons who meet the eligibility requirements for the performance of their duties. They must be of acknowledged commercial and professional integrity, have the appropriate knowledge and experience to perform their duties, and be able to exercise good governance of the institution.

The requirements mentioned above must also be applied to directors or their equivalent, as well as to those responsible for internal control functions and other key positions in the day-to-day financial operations of the credit institution. These persons must be of good repute, demonstrating personal, commercial and professional conduct that casts no doubt on their ability to manage the institution. They must be persons with the appropriate educational profile, particularly in the areas of banking and financial services, as well as having practical experience derived from previous positions. They must possess the appropriate knowledge and experience to perform their duties at the credit institution.

In assessing the ability to exercise good corporate governance, potential conflicts of interest and the ability to devote sufficient time to perform the relevant functions will be taken into account.

An assessment of the suitability requirements shall be carried out, both individually and for the entire board.

### Roles and Accountability Requirements

In Spain, there is no system like the UK's Senior Management Regime. There is no dual administration system, and the board of directors assumes the functions of management and supervision.

The board of directors has the following functions, which cannot be delegated:

- monitoring, controlling, and periodically assessing the effectiveness of the corporate governance system, adopting the appropriate measures to resolve its deficiencies when necessary;
- assuming responsibility for the administration and management of the bank; approving and monitoring the implementation of its strategic goals, risk strategy and internal governance;
- ensuring the integrity of the accounting and financial information systems, including financial and operational control and compliance with applicable legislation;
- overseeing the information disclosure process and communications; and
- ensuring effective supervision of senior management.

In the case of listed banks, the list of tasks that cannot be delegated is longer.

## 4.3 Remuneration Requirements

The remuneration requirements in Spain are outlined in Law 10/2014, Royal Decree 84/2015, and Circular 2/2016.

### Remuneration Policy and Principles

#### *General principles*

As a general principle, credit institutions must have a remuneration policy applicable to all staff (including related agents). This policy must be consistent with sound and effective risk management and refrain from assuming risks that exceed the tolerated level. Additionally, it must be in line with the business strategy, objectives and values, as well as long-term interests, and it must incorporate the measures necessary to avoid any conflict of interest.

Moreover, Spanish regulation provides specific sound remuneration principles for members of senior management, staff whose professional activities significantly affect the credit institution's risk profile ("risk takers"), staff engaged in control functions, and any employee receiving full remuneration in the same bracket as senior management and risk takers (provided their professional activities have a material impact on the institution's risk profile).

#### *Variable remuneration*

The principles applicable to establishing variable remuneration, which includes stringent requirements, are particularly relevant and apply not only to credit institutions but to all the entities of a banking group. This may create a disadvantaged position for those financial entities (investment firms or management companies) that are not part of a banking group, which may therefore be more flexible and competitive when establishing staff remuneration.

#### *Other requirements*

There are also specific requirements for the members of the management board, whose remuneration must be approved by the General Meeting of Shareholders, as well as for compliance and risk management staff.

In addition to those principles, there are reporting obligations to the Bank of Spain, aimed at verifying compliance with the applicable rules.

#### Supervision

This is in line with the increasing supervisory scrutiny of the Bank of Spain and other European and local regulators, which, in recent years, have launched a number of initiatives to control and (in some cases) limit banking bonuses.

This supervisory pattern also extends to other sectors, such as the securities market. As such, the CNMV has amended the Good Governance Code of Listed Companies to clarify remuneration for the executive members of the board.

#### Breach

Failure to comply with remuneration requirements in Spain is considered a very serious or serious infringement, depending on the relevance of the specific rules breached or the economic and financial position of the credit institution. Therefore, the sanctions imposed are, in the first instance, a fine, withdrawal of authorisation, and public reprimand, among others, and, in the second instance, a fine and public reprimand.

While these obligations are subject to the principle of proportionality, setting remuneration systems that are aligned with the legal framework and simultaneously capable of attracting talent to a banking group is an increasingly complex task that requires expert advice. It has become an issue of strategy rather than human resources.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

The main AML/CTF requirements in Spain are set out in Law 10/2010 of 28th April, on the prevention of money laundering and terrorist financing (Law 10/2010) and its implementing Royal Decree 304/2014.

The basic requirements contained in these regulations are fairly aligned with the EU AML and counter terrorist financing (AML/CTF) framework and can be summarised as follows:

A few features from certain Spanish requirements are the following:

- internal controls and procedures (including the obligation to have in place an AML/CTF Manual and an internal risk self-assessment). Under the Spanish regime, the entities' AML/CTF internal control measures are subject to an annual audit review by an external expert;
- customer due diligence measures;
- reporting obligations, which include some local additional requirements for financial institutions such as:
  - (a) monthly systematic reporting to SEPBLAC of specific transactions with certain features; and
  - (b) reporting by credit institution to the Centralised Banking Account Register (*Fichero de Titularidades Financieras*) of certain information regarding the opening and closing of bank accounts; and
- record-keeping requirements, which apply for a period of ten years (whereas the EU Directive establishes a five-year term). However, after five years, the documents can only be accessible by the internal control units of the entity and the people in charge of its legal defence.

In September 2018, Law 10/2010 was amended to implement Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015, on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (known as the Fourth AML/CTF Directive or the Directive), which is still ongoing. In this regard, Royal Decree 304/2014 is still pending updates.

#### Spanish Implementation of the Fourth AML/CTF Directive

The main amendments introduced to Law 10/2010 are the following:

- covered institutions are required to create an internal whistle-blowing channel to report potential infringements of AML/CTF regulations committed within the institutions;
- creation by SEPBLAC of a public channel to report breaches of AML/CTF regulations;
- the definition of ultimate beneficial owner (UBO) and enhanced due diligence measures applicable to politically exposed persons (PEPs) are amended to align them with the Directive;
- where the group includes several covered institutions, the money laundering reporting officer appointed to SEPBLAC must be a member of the board of directors or a top executive of the group's parent company; and
- an increase in the severity of penalties for breaching AML/CTF regulations.

#### Spanish Implementation of the Fifth AML/CTF Directive

Finally, Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (known as the "Fifth AML/CTF Directive") has not been implemented yet and it is uncertain when the implementation will take place.

In June 2020, the Spanish Ministry of Economy released a preliminary draft of the implementation bill for public hearing. The draft, among other relevant changes, foresees the creation of a new and unique register overseen by the Ministry of Justice, which will contain all the necessary UBO information of all Spanish companies and legal instruments.

Spain has already been warned by the European Commission for the late implementation of the Fifth AML/CTF Directive.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

### Regulatory Framework and Administrators

The Spanish deposit guarantee scheme is the Spanish Deposit Guarantee Fund of Credit Institutions (the FGD or the "Fund"), regulated by Royal Decree-Law 16/2011 and Royal Decree 2606/1996.

Royal Decree-Law 16/2011 unified the three deposit guarantee schemes that existed (one for banking establishments, another for saving banks, and a third for credit co-operatives) into a single Deposit Guarantee Fund for Credit Institutions, which maintains the functions and characteristics of the three funds it replaced.

The Fund, which is a legal entity, is managed by a Management Committee with 11 members: one representative from the Ministry of Economic Affairs and Digital Transformation (formerly, the Ministry of Economy), one from the Ministry of Finance, four appointed by the Bank of Spain, and five designated by the associations representing the credit institutions.

### Types of Deposits, Depositors, and Limits

The Fund covers:

- deposits in savings accounts, current accounts, and fixed-term deposits up to the limit of EUR100,000; and
- transferrable securities and financial instruments up to the limit of EUR100,000, entrusted to a credit institution.

In addition, the Fund also covers the following types of deposits, regardless of their amount, during the three months after the funds have been credited or the deposits have become legally transferable:

- deposits from real estate transactions involving private residential properties;
- deposits from one-off payments received by depositors that are linked to marriage, divorce, retirement, dismissal, disability, or death; and
- deposits concerning insurance payments or indemnity payments for damages due to criminal acts or judicial errors.

These guarantees apply per single depositor, whether they are private individuals or legal entities, regardless of the number and class of monetary deposits they hold with the same credit institution. This limit also applies to depositors holding deposits exceeding the maximum guaranteed amount (EUR100,000, or its equivalent in another currency).

### Depositors Excluded from the Coverage

However, not all legal entities qualify as depositors eligible for the guarantee, since the FGD regime excludes, among others, the following from its coverage:

- deposits made by other credit institutions on their own behalf and in their own name;
- deposits made by the following institutions and companies:
  - (a) investment firms;
  - (b) insurance undertakings;
  - (c) real estate investment companies;
  - (d) management companies of (i) undertakings for collective investment in transferable securities, (ii) pension funds, (iii) securitisation funds, or (iv) private equity institutions;
  - (e) deposits of the entities managed by the management companies mentioned in the paragraph above;
  - (f) private equity institutions;
  - (g) financial institutions, as defined in Article 4.1.26 of Regulation (EU) 575/2013, including payment institutions; and
- deposits held by the institution on behalf of public administrations.

All Spanish credit institutions are mandatory members of the Fund, as are branches in Spain of non-EU credit institutions provided their deposits are not covered by similar regulations in their home country.

### Funding

The FGD is funded in the following ways:

- annual contributions required of all Fund members, calculated according to the amount of each institution's guaranteed deposits and its risk profile;
- other contributions required by the Fund among the members, distributed according to the base calculation of the contributions and with the limits determined by regulation; and
- resources raised on the stock markets, through loans, or any other debt transactions.

In any case, if the Fund's assets are insufficient enough to affect its ability to carry out its functions, it will take the necessary actions to restore them.

Additionally, the deposit guarantee compartment of the Fund may be fed by the payment commitments of the member institutions, provided that such commitments:

- are fully backed by guarantees of low-risk assets, free of charge and freely available to the Fund; and
- do not exceed 30% of the total resources available to the compartment.

Royal Decree-Law 16/2011 specifies the sanctioning regime with penalties for those entities not complying with their Fund obligations.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

In Spain, there is no specific law regulating bank secrecy. The concept of bank secrecy is less specific in Spain than in other jurisdictions or countries where taxation is lower. Nevertheless, the requirements applicable to this concept are extracted from several laws.

### *The Spanish Constitution and the Civil Code*

The Spanish Constitution guarantees the right to honour, personal and family privacy, and self-image. Therefore, banks must protect the honour, privacy, and image of individuals.

Similarly, the Civil Code establishes due diligence obligations in contractual relationships.

Consequently, as one of their tasks, bank employees and even the bank itself have the obligation to keep their clients' banking information confidential under their existing contractual relationship.

### *Law 10/2014*

In addition to the above, credit institutions are required to comply with the requirements of Law 10/2014, which foresees the duty of reservation (commonly referred to as the "secrecy duty") regarding their clients' information.

### Relationships and Information within Bank Secrecy

According to Law 10/2014, credit institutions must comply with the duty of secrecy regarding all financial client information, including their balances, positions and transactions. This information cannot therefore be communicated to third parties nor disclosed in any way.

Additionally, under Regulation 2016/679 on data protection (GDPR), credit institutions will include their clients' personal data in the scope of the bank's secrecy requirements. Data processors and controllers will also implement measures to ensure that data processing complies with regulations. To that end, Organic Law 3/2018 of 5th December, on Personal Data Protection and Guarantee of Digital Rights, establishes that credit institutions must consider, among others, the risk of losing confidential client data to determine if they need to perform the impact assessment under GDPR.

### Permitted Disclosures

Credit institutions will provide information requested by competent national authorities, such as the Bank of Spain, the CNMV, or the DGSFP, enabling these authorities to carry out their supervisory activities. Specific disclosures of information are foreseen in different regulations, such as the following:

### *Royal Decree of 14 September 1982 enacting the Criminal Prosecution Law*

This law foresees a general exception whereby any person who is aware of a crime because of his or her position, function, or profession is obliged to report it immediately to the Public Prosecutor's Office, the competent court, the investigating judge, or the police in the case of flagrant crimes.

### *Law 10/2014*

Information may be disclosed:

- when the client or the law grants permission to notify a third party;
- to comply with information requests from the relevant supervisory authorities;
- to fulfil the obligations under AML/CTF regulation; and
- to comply with GDPR provisions.

In this case, Organic Law 3/2018 sets forth that the Data Protection Officer will have access to the personal data even if the data is covered under professional secrecy.

Exchanges of information are also exempt from the duty of secrecy between credit institutions belonging to the same consolidated group, according to Law 10/2014.

### *Organic Law 6/1985 of 1st July, on Judicial Power*

This law regulates the obligation of all individual persons and public and private entities to collaborate during judicial processes as required by the courts and tribunals, with the exceptions foreseen by law. In this respect, the Criminal Prosecution Act establishes the following exceptions to providing testimony in the judicial process:

- the defendant's relatives in direct ascending and descending lines, and spouses;
- the defendant's attorney regarding the facts entrusted to him or her as defender; and
- the translators and interpreters of the conversations and communications between the above persons.

***Common Reporting Standard (CRS) and Foreign Account Tax Compliance Act (FATCA)***

CRS is the approved model for members of the Organisation for Economic Co-operation and Development (OECD), and it allows the automatic exchange of financial information between countries for tax purposes. This exchange permits tax administrations of member countries to periodically have tax information on the investments or positions of their taxpayers in financial entities located abroad.

Similarly, FATCA covers a similar data exchange with the Internal Revenue Service of the United States.

**Breach**

Any breach of the duty of secrecy is considered severe, punishable by a fine under Law 10/2014.

Also, aside from disciplinary consequences for the employee, a breach could result in investigations into the liability of both the employee towards the entity, and of the entity towards the client as part of the contractual relationship.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

The global frame of reference in the field of banking supervision in Spain is embodied in Basel III, which establishes measures related to risk management, governance, transparency, capital, liquidity and excess leverage.

Basel III has been incorporated into the European Union regulation through:

- Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, known as CRD IV, modified by Directive 2019/878/EU of 20 May 2019.

This Directive focuses on the access requirements for the activity of credit institutions, the principles of prudential supervision, review processes and capital buffers.

- Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013, on prudential requirements for credit institutions and investment firms (CRR), modified by Regulation (EU) 2019/879 of 20 May 2019.

CRR contains the obligations related to own funds and capital requirements, as well as the definitions and requirements on liquidity and leverage. It also contains information disclosure requirements.

Both obligations entered into force on 1 January 2014. These regulations are further detailed in secondary regulations which, in most cases, are developed by the European Banking Authority (EBA).

**Incorporation into National Legislation**

- CRR is directly applicable and, although it does not require implementation, it contains provisions that call for national development. To that end, the Bank of Spain published Circulars 2/2014 and 2/2016.
- CRD IV was implemented in Spain through the approval of:
  - (a) Royal Decree-Law 14/2013 of 29 November, on urgent measures for the adaptation of Spanish law to European Union regulations on the supervision and solvency of financial institutions ("RDL 14/2013").
  - (b) Law 10/2014 of 26 June, on the regulation, supervision, and solvency of credit institutions.
- The most notable consequence of the implementation of the RDL 14/2013 is the allowance of certain tax assets to be computed as capital, as is done in other EU Member States.

Lastly, the aforementioned Spanish regulations are currently undergoing a parliamentary process which will amend and align them with the new European requirements (May 2019 amendments).

**Objectives of the Regulatory Framework**

The fundamental objective is to ensure that entities have sufficient capacity to face unexpected losses as a result of their activity. Therefore, the framework focuses mainly on three aspects:

- the need for greater quantity and quality of capital;
- the reduction of procyclicality of banking activity and its influence on capital requirements; and
- the avoidance of systemic risk.

**Measures Applied to Achieve the Objectives**

***Modification of minimum capital requirements, including the following***

- Defining the different capital ratios, restricting the elements that are included as capital with greater loss-absorbing capacity (common equity tier 1 or CET1) and giving greater

weight to CET1 in the composition of the required minimum equity.
- Increasing capital deductions and their application mainly on CET1 (this was gradually implemented according to a transitional calendar throughout 2019).
- Including a capital conservation buffer of 2.5% of risk-weighted assets, seeking to increase the quantity and quality of capital to be used in times of crisis. In the event of non-compliance with this additional requirement, regulation imposes limits on the distribution of profits and repurchase of shares, among others.

*Definition of capital buffers*

Regulation determines certain buffer tiers and establishes that institutions which (i) do not meet the combined buffer requirements or (ii) distribute CET1, implying reduction to a level where the combined requirement is no longer respected, must calculate the maximum distributable amount of profits.

*Leverage requirements*

The minimum requirement is 3%, to which 50% of the global systemic entity buffer is added for these entities.

These capital requirements, which determine whether a credit institution can access banking activities, are complemented by additional requirements imposed by the supervisor.

This additional capital requirement (or "supervisory capital") is specific to each entity as a result of the supervisory review and evaluation process (SREP). The SREP includes a global assessment of the strategies, processes, and risks of credit institutions, and adopts a one-year and three-year vision to determine the amount of capital and liquidity that each institution needs to cover the risks/obligations assumed in a standard scenario; specifically in a sufficiently probable adverse scenario.

Once the SREP has been carried out, the supervisor will notify each entity of its solvency requirements, as summarised below.

- Total SREP capital requirement (TSCR), which is made up of the minimum capital requirement of Pillar 1 (8%) and the requirement of Pillar 2 (P2R) that must be covered with CET1. This requirement is mandatory for all entities and is used to calculate the maximum distributable amount (MDA).
- Capital conservation buffer requirement, also taken into consideration for the MDA.
- Pillar 2 Guidance (P2G) that should be covered with CET1. The P2G is not mandatory. However, the supervisor and the market expect entities to maintain this buffer. As this is a recommendation and is not mandatory, it is not considered for the MDA.

The TSCR, together with the combined capital buffer requirements, form the overall capital requirements (OCR). This "supervisory capital" is obtained by including P2G in the OCR.

**Liquidity Risk Management**

The following two new indicators have been created to monitor liquidity risk.

*Liquidity coverage ratio (LCR)*

Institutions are required to hold high-quality liquid assets on their financial statement that can, in crisis situations, be quickly liquidated without significantly affecting the value of the company. The exact components of the LCR are published in Delegated Regulation (EU) 2015/61.

*Net stable financing ratio (NSFR)*

The NSFR promotes the use of long-term assets covering long-lived assets. Definition is still pending development by the EBA.

A minimum level of 100% is required for both ratios.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

**Legal Framework**

The insolvency, recovery, and resolution of banks are regulated by Law 11/2015 of 18 June 2015 on the recovery and resolution of credit institutions and investment firms ("Law 11/2015") and its implementing Royal Decree 1012/2015 of 6 November 2015.

They incorporate European regulations, such as the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulations (SRM), into Spanish law.

**Principal Means of Resolution**

Under this legal framework, Spanish regulation holds a model that distinguishes between two functions:

- preventative resolution, which is the responsibility of the Bank of Spain and the CNMV, for credit institutions and investment firms, respectively; and
- executive resolution, the responsibility of which falls on the Spanish resolution fund (*Fondo de Resolución Ordenada Bancaria*, FROB), in relation both to credit institutions and investment firms.

Along with the resolution strategy, the principal means of resolving a failing bank are:

- The sale of the entity's business, which the FROB agrees on and executes, transferring the following to any buyer that is not part of a bridge entity:
  (a) the shares, equity capital contributions, or instruments issued by the entity subject to resolution; and
  (b) all assets, rights, or liabilities of the entity in resolution.
- The transfer of assets or liabilities to a bridge entity: the FROB may agree and execute the transfer to a bridge entity of:
  (a) the shares or other equity instruments issued by the entity subject to resolution;
  (b) all or any assets, rights, or liabilities of the entity in resolution.
- A bridge entity is a public limited company controlled by the FROB in which it may hold a stake, as well as any other authority or public financing mechanism. The ultimate purpose of the bridge entity is the sale of the bank in question to a third party within the specific period stipulated by the regulations.
- The transfer of assets or liabilities to an asset management company: the FROB has the power to transfer assets, rights, or liabilities of an entity subject to resolution or a bridge entity to one or more asset management companies.
- Bail-in: once the pertinent loss-absorption has occurred, the FROB may transform creditors into shareholders and/or reduce the nominal value of their debts, following the rules and procedures established by regulation (in keeping with the creditor hierarchy).

#### Implementation of FSB Key Attributes of Effective Resolution Regimes (FSB keys report)

Spain has implemented the FSB Key Attributes, as they are closely aligned with the European regulations that have been incorporated into Spanish law.

More specifically, the main objectives and principles of the FSB Key Attributes are established in the Spanish resolution scheme, as follows:

- resolution authority – as mentioned, Spain has two designated administrative authorities responsible for exercising resolution power over firms within the scope of the resolution regime;
- resolution powers – as indicated above, the resolution toolkit is the same as established in the FSB keys report;
- funding of firms in resolution: Spain has privately financed deposit insurance funds in place, as well as a funding mechanism with ex-post recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm;
- legal framework conditions for cross-border co-operation: Spanish authorities have formalised cross-border co-operation agreements;
- resolvability assessments – the entities are subject to regular resolvability assessments; and
- recovery and resolution planning: the entities must have a recovery and resolution plan in place, which must be subject to ongoing assessment and updates.

#### Applicable Rules for Deposits

In relation to the insolvency preference rules applicable to deposits, Spain relies on the Deposit Guarantee Fund for Credit Institutions (*Fondo de Garantía de Depósitos de Entidades de Crédito*); a private institution in charge of deposit guarantees of up to EUR100,000 per depositor and credit institution.

In this context, Law 11/2015 grants maximum preferential treatment in the hierarchy of creditors to deposits guaranteed by the Deposit Guarantee Fund for Credit Institutions, and a general privilege to all deposits from SMEs and natural persons.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

Banks suffer from great regulatory pressure due to a wide range of regulations, both specific to their activities and cross-regulations, such as AML or consumer protection laws. Although the regulatory framework is mostly determined at an EU level, banks must also consider local requirements.

Regulatory requirements have increased since the financial crisis of 2008. Today, European and Spanish legislators are focused on:

- reviewing the effectiveness of the measures implemented in the past;
- pushing to harmonise requirements applicable in the financial sector to ensure a level playing field for new and existing players in the EU; and
- creating new initiatives to complete the Capital Markets Union (CMU) and boost digitisation, while ensuring a sustainable and green economic transition for the EU.

In this context, the analysis of regulatory requirements applicable to banks must consider the fact that banks provide investment services, significantly expanding the number of regulations under assessment.

Given the foregoing, the authors have highlighted the upcoming regulatory challenges that banks will face in different areas, summarising the main impacts of each one.

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**Prudential and Governance Requirements**

The modifications to CRD IV and CRR introduced by Directive 2019/878 (CRD V) and Regulation 2019/876, respectively, aim to harmonise the interpretations of certain aspects regulated under CRD IV and adapt the framework to the international standards developed by the Basel Committee on Banking Supervision (BCBS).

In the short term, banks will need to:

- adapt to the new requirements applicable to remunerations (29 December 2020), which include implementing a gender-neutral remuneration policy;
- comply with other requirements related to interest risk arising from non-trading book activities (28 June 2021) or combined buffer requirements (1 January 2022); and
- assign a risk weight of 100% to exposures fully secured by mortgages on immovable property when certain conditions are met, or provide own estimates of Loss Given Default in certain cases (28 December 2020).

**MiFID II and Environmental Social and Governance (ESG) Initiatives**

Banks have already implemented major changes to adapt to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, on markets in financial instruments (MiFID II) introduced in 2018, which were already challenging, especially those related to inducements, research, transparency, costs and charges, and product governance obligations.

The European Commission has reviewed the impact on the industry linked to MiFID II requirements to:

- ensure that some of the requirements are more proportionate; and
- reduce the administrative burden created when providing investment services to certain types of counterparties.

Additionally, the European Commission has proposed certain urgent amendments (also known as quick fixes) to mitigate the administrative burden and support the economy due to the impact of COVID-19.

***Quick fixes***

The proposal to amend MiFID II includes several modifications that will impact banks' existing processes and models. These include:

- phasing out the paper-based default method of communication;
- introducing an exemption for eligible counterparties and professional clients from cost and charges information;
- allowing the delayed transmission of information costs when using remote communication channels;
- alleviations for service reports (such as 10% portfolio losses report);
- opting in cost benefit analyses for professional investors in the event of product switching;
- lifting the product governance requirements for simple corporate bonds with make-whole clauses; and
- suspending the requirement to publish the best execution report.

The date on which the proposed urgent modifications will apply has yet to be determined. However, it seems likely that it will be 31 December 2020.

***MiFID II review***

In addition to these quick fixes, the European Commission is assessing the effectiveness of MiFID II obligations, especially those related to inducements, research, product governance and others concerning minimum records.

These will also directly impact existing processes and business models adapted to comply with the incentives regime and the prohibitions set out under regulation (stricter in Spain after implementation). Amendments to the requirements concerning minimum records will also affect internal systems, databases, and even agreements with third-party providers.

These aspects will need to be reviewed by investment firms to achieve an effective administrative cost reduction.

In addition to the MiFID II review, banks will need to assess the impact of the European Commission Action Plan on financing sustainable growth, which sets forth several legislative initiatives that, among other actions, will require affected credit institutions to determine their strategic positioning around ESG obligations. Credit institutions must decide whether to embrace the change to a green EU economy and provide support at the outset, ahead of their competitors. However, regardless of positioning or strategy, affected entities will need to adapt to the new obligations, some of which are summarised below.

- New governance requirements (most applicable as of 10 March 2021):
  - (a) integrate sustainability risks and factors, defining a specific integration policy;
  - (b) certain pre-contractual disclosure obligations; and
  - (c) a remuneration policy that considers sustainability risks, among others.
- New requirements when providing investment advice and portfolio management (Q1 2021):

(a) integrate ESG factors and risks;
(b) adapt suitability tests; and
(c) update control and governance processes of financial instruments.

#### Challenges and opportunities

On the one hand, the proposed MiFID II amendments should simplify the provision of investment services by banks and investment firms. On the other hand, ESG initiatives affect several aspects of financial institutions and implement new requirements. However, both MiFID II updates and the new ESG framework could be a great opportunity for these companies:

- to reduce mid- and long-term costs and increase quality in the provision of services by:
  (a) enhancing existing processes;
  (b) integrating solutions and simplifying systems/databases; and
  (c) improving the end-to-end model; and
- for market positioning and expansion of their target market by:
  (a) standing out from competitors by becoming an ESG reference in the market (benefiting from time-to-market);
  (b) increasing the product offering; and
  (c) reducing reputational risks.

### Capital Markets Union (CMU): European Commission Action Plan

It is also worth noting the European Commission CMU Action Plan since, it could be said, it entails actions that would impact the regulatory framework of financial institutions, among others.

The objective of this Action Plan is to:

- implement measures that support a green, digital, inclusive, and resilient economic recovery by making financing more accessible to companies;
- make the EU an even safer place for individuals to save and invest long-term; and
- integrate national capital markets into a genuine single market.

Some of the most relevant steps for financial institutions are:

- a review of the EU securitisation framework for both simple, transparent and standardised (STS) and non-STS securitisation (Q4 2021);
- a review of the procedures and conditions under which Central Securities Depositaries (CDS) have been authorised to designate credit institutions or themselves to provide banking-type ancillary services (Q4 2021);
- initiatives towards minimum harmonisation or increased convergence in targeted areas of core non-bank insolvency (Q2 2022);
- put forward a legislative initiative to lower tax-related costs for cross-border investors and prevent tax fraud, and explore additional ways to introduce a common, standardised, EU-wide system for withholding tax relief at the source (Q4 2022);
- assess the effectiveness of national loan insolvency systems, analysing the possibility of making legal amendments to reporting frameworks (Q1 2021). This could lead to legal amendments in Q4 2022; and
- assess the possibility of introducing an EU-wide, harmonised definition of “shareholder”, and clarify the rules governing the interaction between investors, intermediaries and issuers, as regards the exercise of voting rights and corporate action processing (Q3 2023).

### Upcoming Spanish Initiatives to Be Considered by Banks

In addition to the amendments of existing regulations and the new regulatory requirements under European regulations described above, banks must monitor Spanish legislative initiatives. These include the following:

#### The Spanish Financial Transaction Tax Law

The Spanish financial transaction tax law will be applicable as of 15 January 2020.

Although the purchaser of the securities is the taxpayer, in general, the financial intermediary who transmits or executes the acquisition order is affected by the purchase. Therefore, banks will need to review their processes to ensure they identify the transactions and the clients subject to taxation.

#### Implementation of the Fifth AML/CTF Directive

Banks will also be impacted by some of the new aspects regulated by the Directive 2018/843 of the European Parliament and of the Council of 30 May 2018, amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (Fifth AML/CTF Directive).

The implementation of the Fifth AML/CTF Directive in Spain is currently in the parliamentary phase, although the implementation deadline ended on 10 January 2020.

Obliged entities, including credit institutions, will need to consider both certain changes introduced by this Directive and the proposed amendments to Spanish Law 10/2010. Aspects subject to change include:

- the definition of Person of Public Responsibility, now expanded to include persons with regional and local responsibility among political parties;
- some requirements applicable to the verification of the client entity or electronic signature, adjusted to online identification processes;
- the external expert, for which a stricter framework has been introduced; and
- the registry of beneficial owners, which will depend on the Ministry of Justice and will be centralised by the Commercial Registry and the General Notary Council.

#### *Implementation of Directive 2017/828 as regards the encouragement of long-term shareholder engagement (SRD II)*

SRD II is designed to encourage long-term shareholders and enhance transparency between investors and companies. This Directive, in the process of being implemented in Spain, will affect banks because they often serve as intermediaries.

According to SRD II, intermediaries will be required, in some cases and upon request from a company, to provide the company with information regarding shareholder identity. SRD II also establishes the obligation of intermediaries to publish their applicable service rates on their websites, to facilitate the exercise or delegation of the rights of representation and voting.

Furthermore, SRD II imposes transparency obligations on institutional investors and asset managers, regarding the extent to which investments are made in shares traded on a regulated market.

A policy of SRD II requires entities to disclose shareholder engagement, describing how shareholder engagement is integrated into their investment strategy. This policy looks to disclose how an entity does the following:

- monitors investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance;
- conducts dialogues with investee companies;
- exercises voting rights and other rights attached to shares;
- cooperates with other shareholders;
- communicates with the relevant stakeholders of investee companies; and
- manages actual and potential conflicts of interests in relation to their engagement.

Additionally, institutional investors and asset managers are required to publicly disclose, on an annual basis, how their engagement policy is implemented. This must include a general description of voting behaviour, an explanation of the most significant votes, and the use of proxy adviser services. Such disclosures may exclude votes that are insignificant due to the subject matter of the vote or the size of the holding in the company.

The proposed law regarding the encouragement of long-term shareholder engagement (which will implement SRD II) will enter into force 20 days following its publication in the Spanish Official State Gazette.

#### *Requirements applicable to advertising banking and investment products and services*

In 2020, banks will need to take into consideration updates to the rules governing the advertisement of banking and investment services and products. The Spanish rules, currently comprising the regulatory framework, are the following:

#### *Bank of Spain Circular 4/2020 on advertising banking products and services ("Circular 4/2020")*

This Circular introduced several modifications to the previous advertising regime. For example, it now includes payment services and foreign entities that carry out commercial activities in Spanish territories though a branch, agent, or under the Freedom to Provide Services regime. It also extends the definition of advertising to that performed on the internet, mobile devices (banners, buttons and pop-ups), social media or direct advertising (letters, emails and coupons).

Finally, it establishes the need to implement a commercial communications policy (to be approved by the management body), and create and maintain an internal registry of commercial activities.

Though most of the requirements are applicable from 15 October 2020, financial entities will need to create the internal registry six months after the technical specifications are published by the Bank of Spain.

### Proposed Circular from the CNMV Regarding Requirements for Advertising Investment Products and Services

The proposed Circular will enter into force three months after its publication in the Spanish Official State Gazette.

Overall, it is consistent with the definitions, message and format previously established in Circular 4/2020, continuing to set forth the obligation to maintain an internal registry. However, its scope varies in that it now applies to all products, services, and activities under CNMV supervision and to all entities supervised by the CNMV.

### Conclusions

The regulatory framework is vast, complex, interconnected and ever-changing. This increases regulatory and reputational risk.

Consequently, banks must ensure that their internal control systems and governance frameworks are reviewed frequently and that synergies are in place to ensure the entity complies in an efficient, proportionate, and safe manner.

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**finReg360** advises both foreign and Spanish financial clients in the legal areas of security markets, banking, insurance, collective investments, private equity, AML/CTF and fintech. The firm assists leading financial organisations in adapting to regulations; ie, ESG, MiFID II, IDD, PSD2, AIFMD, MCD, GDPR, MAR and SFTR. It assists organisations in incorporating regulated investment firms, collective investment schemes and institutions, payment institutions, investment platforms, crowdfunding and private equity institutions. Additionally, the firm supports regulated entities through its Mystery Shopping and regulatory radar services. Recently, it launched finRegCampus: a platform providing online courses so that regulated entities can easily undertake periodic training in compliance with regulations such as MAR, AML, MiFID, etc. finReg60 boasts a team with proven experience in business and regulatory operational consulting of the financial industry, as well as a specialised tax team to provide advice on all types of tax matters.

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# SWEDEN

## Law and Practice


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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Key Laws and Regulations

As Sweden is an EU Member State, Swedish banks are subject to laws and regulations on an EU level and a national level. Consequently, Swedish banks are subject to national laws implementing the Capital Requirements Directive (2013/36/EU) (the CRD) and directly subject to the Capital Requirements Regulation (EU No 575/2013/EU) (the CRR), which are the two key European legislative acts that govern the Swedish banking sector.

On a national level, Sweden has implemented the CRD through the Banking and Financing Business Act (2004:297) (the BFA). The CRR is directly applicable in Sweden but has been complemented with certain Swedish rules, including the Credit Institutions' and Investment Firms' (Special Supervision) Act (2014:968) (the Special Supervision Act) and the Capital Buffers Act (2014:966) (the CBA). The relevant acts set out general prudential and organisational requirements with which Swedish credit institutions (including banks) must comply. For banks that are limited liability companies, the general Swedish Companies Act (2005:551) (the Companies Act) is also an important piece of legislation that has an implication on the corporate governance of Swedish banks.

Banks that provide investment services are subject to the Securities Market Act (2007:528) (the SMA), implementing MiFID 2 (2014/65/EU). Other key legislation containing requirements in relation to specific financial services includes the Payment Services Act (2010:751) implementing PSD2 (EU) 2015/2366, and the Consumer Credit Act (2010:1846), regulating consumers' rights in relation to credits offered to consumers.

Swedish banks are subject to the Anti-Money Laundering and Terrorist Financing Act (2017:630) (the AMLA), implementing the AML Directive (EU) 2015/849, which stipulates requirements in relation to the prevention of money laundering and terrorist financing.

In relation to depositor protection and the crisis management of banks, the Deposit Guarantee Act (1995:1571) (the DGA) (providing for the Swedish deposit guarantee scheme) and the Resolution Act (2015:1016) implementing the Banking Recovery and Resolution Directive 2014/59/EU are key pieces of legislation.

Swedish laws are supplemented by regulations (mandatory rules) and guidelines (comply or explain principle) issued by the Swedish regulator and financial supervisory authority, the Swedish Financial Supervisory Authority (*Finansinspektionen*) (the SFSA). Furthermore, the guidelines of the European Banking Authority (EBA) generally apply to Swedish banks, either directly through confirmation by the SFSA or as further implemented by SFSA regulations or guidelines. Upon confirmation by the SFSA, EBA guidelines have the same legal status as the SFSA guidelines.

### Regulatory Authorities

The SFSA is the primary regulator in the financial sector and is responsible for the authorisation and supervision of Swedish banks. The SFSA's objective is to ensure stable financial systems, by promoting confidence, well-functioning markets and a high level of consumer protection.

The Swedish National Debt Office (*Riksgälden*) is responsible for the resolution of banks and the national deposit guarantee scheme. The central bank of Sweden (*Riksbanken*) acts as a lender of last resort but does not have any supervisory function in relation to banks.

Other relevant regulatory authorities include the Data Protection Authority (*Datainspektionen*), which supervises compliance with the General Data Protection Regulation (EU) 2016/679 (GDPR), and the Consumer Agency (*Konsumentverket*), which has certain supervisory powers regarding the marketing of and disclosure requirements in relation to consumer credits.

Although a member of the EU, Sweden does not participate in the European banking union and the institutional frameworks referred to as the "Single Supervisory Mechanism" and the "Single Resolution Mechanism" (the SRM). Therefore, the European Central Bank (the ECB) does not have any direct authority in relation to the licensing and supervision of Swedish banks.

# 2. Authorisation

## 2.1 Licences and Application Process

### Types of Licences and Activities Covered

The BFA regulates Swedish licence requirements that apply to activities carried out by credit institutions. There are two regulated activities in this regard.

The first activity is "banking business" (*bankrörelse*), which captures undertakings that participate in the processing of payments through general payment systems and receive money from the public on their own account, which after termination is available to the creditor within a maximum of 30 days. The second activity is "financing business" (*finansieringsrörelse*), which refers to undertakings that take up deposits and other repayable funds from the public and grant credits for their own account. Companies that are licensed to carry out financing business are referred to in the BFA as credit market institutions.

Conceptually, Swedish banks and credit market institutions are both "credit institutions" within the meaning of the CRD. Accordingly, Swedish banks as well as credit market institutions may provide all sorts of financial services listed in Annex 1 of the CRD. However, institutions that carry out financing business are traditionally less complex than banks, but are in essence subject to the same regulatory requirements as banks. For the purposes of the descriptions below and unless specifically set out below, we will use the word "bank" when describing regulatory requirements applicable to credit institutions in Sweden.

### Other Financial Services

Business that includes only limited financial services, such as residential credits, consumer credits and payment services, but not deposit-taking, is also regulated and subject to licence requirements under separate legal frameworks.

### Foreign Banks

Banks authorised in other European Economic Area (the EEA) Member States (including the EU) may provide banking services in Sweden without obtaining a separate licence from the SFSA. These banks may start to operate in Sweden on a cross-border basis or by establishing a branch office by notifying their home state authority, which will in turn notify the SFSA. Third country banks will need to apply for authorisation in Sweden through establishment in Sweden, and may not provide cross-border services into Sweden.

### Conditions for Authorisation

In order to obtain a banking licence, an applicant must file a comprehensive application to evidence that they will meet the conditions for authorisation, including that:

- the articles of association comply with the BFA and other relevant legislation;
- there is reason to assume that the business will be conducted in accordance with the BFA and other applicable legislation;
- owners of qualifying holdings are deemed suitable to exercise significant influence over the undertaking; and
- members of the board of directors (the board) and senior executives possess the insight, competence and experience necessary to manage a bank.

Furthermore, a bank must have a starting capital corresponding to at least EUR5 million at the time of commencing business once the application has been approved.

### The Application Process

Applications are submitted to the SFSA, which will decide whether the conditions for authorisation are fulfilled. Applicants pay a fee to the SFSA in conjunction with the application, currently SEK420,000.

The application must include information on how the undertaking will fulfil and comply with legal, organisational and prudential requirements. This includes comprehensive and detailed descriptions of the undertaking's internal rules, procedures and methods with respect to internal governance and risk management.

Documents that must be provided in the application include a detailed business plan, annual reports, capital and liquidity assessments and a wide range of required internal policies, as further described under **4.1 Corporate Governance Requirements**. The applicant must also submit information about the owners, management and senior executives for the purpose of the SFSA's assessment with respect to the criteria described under **3.1 Requirements for Acquiring or Increasing Control over a Bank** and **4.2 Registration and Oversight of Senior Management**.

### The SFSA's Assessment

As a formal rule, the SFSA should make its decision to grant or refuse a licence within six months of receiving a formally complete application. As the SFSA usually requests complementary information during the evaluation period, a timeline of 12-18 months from the date an application is filed can be expected. The undertaking must then commence its business operations within a year of the application being granted.

During the evaluation period, the SFSA will communicate with the applicant on an ongoing basis – for example, in order to request complementary information. In general, it is advisable to have regular informal contact with the SFSA's case handler in order to check on the status of the application.

### Recent Developments

As a rule, the application must show that the undertaking will be able to fulfil all of the criteria described in the previous sections as soon as the business operations commence. In recent years, the SFSA has increasingly focused not only on whether the conditions for authorisation are formally fulfilled but also on whether the applicant has a credible and viable strategy and business model, which will allow the applicant to generate returns on a long-term basis.

In the past four to five years, the SFSA has only granted licences to a handful of applicants, and many others have either been subject to non-approval or have withdrawn their application following the SFA's indication that it would not be approved.

For the reasons above and due to the sheer amount of information that must be provided, an application has become a lengthy and costly procedure, which usually requires the involvement of external consultants, such as lawyers with regulatory expertise and capital adequacy experts.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

### Qualifying Ownership

Any individual or entity acquiring a qualifying holding in a bank must be subject to prior approval and ownership assessment by the SFSA. A qualifying holding is defined as a direct or indirect holding of at least 10% of the capital or the voting rights, or which otherwise makes it possible to exercise significant influence over the bank – eg, through veto rights or representation on the board. An approval must also be obtained if a qualifying holding is increased and reaches or exceeds 20%, 30% or 50% of the capital or the voting rights.

Furthermore, an application should be made if several acquirers act in concert and their aggregate holdings amount to a qualifying holding. When determining whether the acquirers act in concert, consideration should be taken inter alia of shareholder agreements and other close ties between the acquirers.

### Requirements in Relation to Owners

There are no formal restrictions regarding the categories of persons that may acquire a qualifying holding – eg, in relation to foreign ownership. However, the SFSA will assess whether the acquirer is suitable to own a qualified holding.

An acquisition will be approved only if it does not impede the sound and prudent management of the bank and its ability to conduct business in accordance with applicable legal requirements. In its assessment, the SFSA will consider the following, among other things:

- the reputation and financial strength of the acquirer;
- the reputation, competence and experience of the management of the acquirer;
- the bank's ability to comply with prudential requirements after the acquisition; and
- if the acquisition has a connection to, or increases the risk of, money laundering or terrorist financing.

If the acquisition results in a "close link" between the bank and the owner or an affiliate of the owner, which is assessed based on certain ownership thresholds, it will only be approved if it does not prevent the effective supervision of the bank.

### Regulatory Filings

The application for approval is made using standard forms provided by the SFSA. The magnitude of the information that must be provided in the application varies depending on the size of the holding that is acquired, but includes information about the organisational structure of the acquirer (including an ownership chain), the acquirer's financial situation and the acquirer's management, as well as business and financing plans.

The SFSA has a handling time of up to 60 working days from the date a formally complete application is filed. During the assessment period, the SFSA may request additional information, in which case the assessment period is suspended.

In order to obtain relevant information about the acquirer, the SFSA will also gather information from other Swedish authorities and, where applicable, foreign authorities.

If the SFSA decides to oppose the proposed transaction, it must inform the proposed acquirer of the decision in writing. The decision may be appealed to the administrative courts of Sweden.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Relevant Legislation and Codes

Key legislation with respect to corporate governance includes the BFA, SFSA regulations and EBA guidelines. For banks that are limited companies, the Companies Act is essential. Furthermore, the Swedish Bankers' Association publishes recommendations, which banks generally follow. Banks that are listed on stock exchanges must comply with the relevant stock exchange rules and with the "Swedish Code of Corporate Governance", an industry code for listed companies.

### General Corporate Governance

From a general perspective, the Companies Act stipulates that Swedish companies must have three decision-making bodies: the shareholders' meeting, the board and the managing director (in hierarchical order). Companies are also required to have an external auditor, which is appointed by the shareholders' meeting.

The board has the ultimate responsibility for the organisation of a company and the management of its affairs. The managing director is responsible for the day-to-day management. The board is required to define and distinguish the duties of the board and the managing director.

In a banking regulatory context, the board is ultimately responsible for the bank's internal governance, its financial situation and its legal compliance. The managing director of a bank is responsible for managing the bank in accordance with the board's instructions.

### Control Functions in Banks

Banks are required to have independent control functions for risk control, compliance and internal audit. These functions monitor and control the bank's operations to ensure that risks are properly managed and legal requirements are met. As a general rule, the functions must be organisationally separated from the business operations and each other.

Banks must adopt internal rules for the control functions, stipulating their responsibilities, duties and reporting procedures. As a rule, the functions for risk control and compliance will report regularly to the managing director and the board, while the internal audit function reports directly to the board.

Banks are required to provide the control functions with enough resources, and staff in the control functions must have sufficient experience and knowledge to monitor the bank's operations.

The control functions may be outsourced to external service providers, subject to certain regulatory requirements for outsourcing.

### Internal Governance and Control

Banks must adopt an adequate and effective written framework for internal governance and control, which should include clearly defined decision-making processes and allocations of responsibilities as well as specified reporting lines.

The governance and control frameworks should take into account the nature and scope of the bank's business, but are in general very comprehensive. Areas where written policies, rules and procedures are a statutory requirement include risk management, anti-money laundering and terrorist financing, compliance, IT systems, business continuity, conflicts of interests, remuneration and outsourcing.

### Outsourcing

Outsourcing arrangements have become increasingly common in Sweden, especially in relation to IT systems and cloud services. In order to ensure that banks maintain control when critical functions or part of the business are outsourced, they must regularly monitor and evaluate the service provider. Critical outsourcing arrangements must be reported to the SFSA.

Continuity management is of the essence in outsourcing arrangements. Banks must ensure that disruptions can be avoided if the external partners fail to provide the services or if the arrangement is terminated. In this regard, it must be possible to transfer the outsourced activities to another service provider or to the bank within a reasonable period upon termination.

## 4.2 Registration and Oversight of Senior Management

### General

Board members in Swedish companies are appointed by the shareholders' meeting, and the managing director is in turn appointed by the board.

Banks are required to adopt a suitability policy with respect to board members and senior management. The policy should set out rules on the appointment procedure and which requirements the relevant persons must meet.

Banks must ensure that the board as a whole, as well as the individual members, has sufficient experience and knowledge in relevant areas – eg, financial markets, legal requirements, risk management and the managing of financial businesses. The diversity of the board as regards age, gender and background must also be considered.

### Registration with the SFSA

Board members, alternate board members, the managing director and deputy managing directors are subject to suitability assessments by the SFSA. An application for a suitability assessment must be filed when an undertaking applies for authorisation and when there is a change in these positions.

Applications are made by using standard form questionnaires. The application must include a curriculum vitae and information about the person's employment and ownership in other undertakings and potential conflicts of interest. When new board members are appointed, the application should include an assessment of the new board member and of the board as a whole.

The SFSA has a handling period of up to 60 working days to assess whether the person is suitable based on their knowledge, experience and reputation.

### Accountability

Please see **4.1 Corporate Governance Requirements** regarding the roles and duties of the board and the managing director. Failure to perform these duties properly may lead to civil liability under the Companies Act if the bank has suffered damages or losses. It may also lead to disciplinary action from the SFSA in the form of administrative fines or a banning order that prevents the person from acting as a board member or managing director in a bank for three to ten years.

### 4.3 Remuneration Requirements

#### Relevant Legislation

The remuneration practices in banks are mainly regulated by the BFA and SFSA regulations. Banks must also comply with EBA's guidelines on remuneration. The legal requirements apply to both monetary and non-monetary benefits.

#### Remuneration Policy

Banks are required to have a written, gender-neutral remuneration policy that must promote sound and effective risk management, may not encourage excessive risk-taking and should include measures to avoid conflicts of interest. Furthermore, the policy should align with the bank's strategy, risk appetite, values and long-term interests.

#### Risk Analysis

Banks are required to carry out an annual analysis in order to identify categories of staff whose professional activities have a material impact on the risk profile of bank ("risk-takers"). Risk-takers will include senior executives, staff in control functions and staff whose remuneration exceeds certain thresholds, among others. Special rules will apply to the remuneration paid to such staff.

#### Variable Remuneration

A distinction is made between fixed and variable remuneration, and the levels of fixed and variable remuneration must be appropriately balanced. Variable remuneration is subject to special restrictions, including that it must be based on both financial and non-financial as well as risk-adjusted performance criteria. As a rule, guaranteed variable remuneration is not permitted other than during the first year of employment.

For risk-takers, the total variable remuneration must not exceed the total fixed remuneration they receive. Furthermore, at least 40% of their variable remuneration above SEK100,000 should be deferred for at least three to five years; if the remuneration is particularly high, at least 60% should be deferred. In larger banks, at least 50% of the variable remuneration of risk-takers should consist of shares or other instruments.

The board is responsible for ensuring that the total variable remuneration paid to staff does not limit its ability to maintain or strengthen its capital base. Variable compensation should be able to be withheld or reduced, if the pay-out could jeopardise the bank's financial situation, for example.

#### Review of Remuneration Practices

The board is required to review the remuneration policy and the risk analysis annually, in order to ensure that actual remuneration practices comply with the policy and the legal requirements. Such a review must also be carried out independently by the control functions.

#### Supervision

Banks are required to disclose information to the public about their remuneration policy and practices on an annual basis, including information about variable remuneration paid to risk-takers. The SFSA also collects information from all Swedish banks on their remuneration practices on an annual basis.

#### Consequences of Breaches

If a bank is in breach of the remuneration requirements, the SFSA may order it to amend its remuneration practices. If the breach is serious, a warning may be given or, in a worst case scenario, the bank's authorisation may be withdrawn. The SFSA may also issue an administrative fine. The board members and the managing director could be subject to the sanctions described under **4.2 Registration and Oversight of Senior Management**.

#### Future Changes through CRD V

During 2021, new remuneration requirements will enter into force as part of the changes to the CRD made through Directive 2019/878/EU (CRD V). The changes will, inter alia, increase the minimum deferral period to four years for general risk-takers and five years for senior management. Smaller banks and staff with annual salaries below EUR50,000 will be exempted from the requirement to defer compensation and pay parts of it in shares.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

Sweden has implemented the Anti-Money Laundering Directive (EU) 2015/849 through the AMLA, which prescribes requirements for the prevention of money laundering and terrorist financing that correspond to the requirements set out in the Directive. The requirements can roughly be divided into three main focus areas:

- general risk assessment;
- customer due diligence; and
- monitoring and reporting.

#### General Risk Assessment

The general risk assessment shall identify how the products and services provided by the bank can be used for money laundering or terrorist financing, and assess the risks associated with money laundering and terrorist financing. In conjunction with the general risk assessment, special consideration shall be given to the types of products and services that are provided, the existing customers and distribution channels, and the existing geographical risk factors. Banks shall conduct a risk assessment of the customers and determine a risk profile for each customer. The customer's risk profile shall be based on the general risk assessment and the knowledge of the customer.

### Customer Due Diligence

A bank may not establish or maintain a business relationship nor carry out an individual transaction where it lacks sufficient knowledge of the customer. Such knowledge is essential in order to be able to handle the risk associated with the customer and to supervise and assess the customer's activities and transactions to identify suspicious activities and potential money laundering or terrorist financing.

Necessary customer due diligence measures include:

- the identification and verification of customers and potential beneficial owners;
- ascertaining whether the customer or beneficial owner is considered a political exposed person or appears on any sanctions list;
- obtaining information regarding the purpose and nature of the business relationship; and
- following up on the information provided.

### Simplified or Enhanced Measures

Depending on the customer's risk profile, simplified or enhanced measures can be allowed or required. If the risk associated with the customer relationship is determined as being high, the business operator shall carry out particularly comprehensive verifications, assessments and investigations. Such measures include obtaining additional information regarding the purpose and nature of the business relationship or transaction information regarding the origins of the financial resources of the customer and the beneficial owner.

### Ongoing Monitoring and Reporting

A business operator shall monitor ongoing business relationships and evaluate individual transactions for the purpose of discovering suspicious activities and transactions. The focus and scope of the monitoring shall be determined based on the general risk assessment and the customer's risk profile. If there is reasonable cause to suspect money laundering or terrorist financing, information regarding all indicative circumstances shall be reported promptly to the Swedish Police.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

### General

The Swedish deposit guarantee scheme (the Scheme) is administered by the Swedish National Debt Office (the NDO). Relevant legislation includes the DGA, the Deposit Guarantee Ordinance (2011:834) and NDO regulations.

The Scheme protects deposits in cases where a due and payable deposit is not repaid by a bank under the applicable legal or contractual deposits, and where the SFSA has determined there are no current prospects of the bank being able to do so, or where the bank has entered into bankruptcy. The Scheme continues to apply if the NDO takes control of a bank in cases of resolution. As of 2020, compensation has been paid out from the Scheme on three separate occasions, for a total amount corresponding to approximately EUR20 million.

"Deposit" in this regard means a credit balance in any kind of bank accounts, such as current accounts and savings accounts, and regardless of whether the deposit is fixed-term or subject to other restrictions.

### Deposits Covered

The Scheme covers deposits with Swedish banks as well as branch offices of Swedish banks in other EEA Member States. Upon a bank's application to the NDO, the Scheme may also cover deposits with branch offices outside the EEA. Swedish branch offices of banks authorised in other EEA Member States may also participate in the Scheme upon application to the NDO. In such cases, the Scheme will supplement the cover provided by the depositor guarantee scheme in the home state.

The Scheme covers deposits, including interest, up to the date on which the SFSA makes a determination that there are no prospects of the bank being able to repay, or up to the date bankruptcy is declared.

Deposits from both individuals and legal persons (including the estates of deceased persons) are protected through the Scheme. However, deposits by financial institutions such as banks, investment firms and insurance companies and public and local authorities made on their own behalf are not covered by the Scheme. Funds found to be connected to money laundering or terrorist financing are not protected.

### Limitations

The maximum amount covered by the Scheme is an amount in SEK corresponding to EUR100,000. The amount nominated in SEK is reviewed and decided by the NDO every fifth year.

As of 1 January 2021, the amount covered will increase from SEK950,000 to SEK1,050,000.

Under certain circumstances, the maximum guaranteed amount covered may be raised to SEK5 million. This is the case with respect to deposits resulting from private residential property transactions and deposits related to divorce, dismissals, pensions, redundancy, invalidity or death, as well as insurance payments and compensation from criminal injuries. However, such higher amounts are only protected for a period of 12 months from the date the deposit was made.

The maximum amount applies per person and bank, which means that a person holding deposits with several banks may receive the maximum amount for each of the banks with which they have made deposits. With respect to joint accounts and client accounts, every individual owner is, as a main rule, entitled to the maximum amount covered.

The protection enjoyed by depositors under the Scheme is not affected if the depositor also has debts with the bank (eg, a mortgage). Debts will therefore not be subtracted from the compensation but are more likely taken over by another bank.

### Information Requirements

Banks are required to inform depositors of the Scheme and whether deposits are covered, the maximum amount covered, and how the guarantee will be paid out.

Banks are also required to submit regular information to the NDO on depositors and their deposits. Information about the total amount of guaranteed deposits at the end of each quarter of a year must be reported no later than 24 January the following year.

### Funding of the Scheme

Each bank that is covered by the Scheme must pay an annual fee to the NDP, which is based on the total amount of deposits received by the bank during the preceding year. The basic annual fee is 0.1% of the total deposits made during the preceding year, but the individual fee per bank is set by the NDO, with consideration given to risk-adjusting factors.

The fees are placed by the NDO in a designated account administered by the NDO itself, from which compensation to depositors is paid when required. This account is generally considered to be well funded but in the hypothetical case that the funds are insufficient to compensate all depositors, the NDO will borrow money from the government.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

The bank secrecy requirements follow from the BFA, although similar requirements are set out in other related legal areas. In the BFA, the bank secrecy requirements are expressed in a way that an individual's relationship to a bank may not be disclosed to a third party. There are some exceptions to this rule; however, they are not explicitly expressed in law, but rather as instances when a disclosure may be permissible.

The requirements are directed towards the bank as a legal person, but apply to management and all employees. If the bank violates the bank secrecy requirements, the bank may face administrative penalties and fees. Such a violation is not classified as a criminal offence.

### Information Covered by Bank Secrecy

Bank secrecy protects all information, documented or not, that a bank holds on a customer, regardless of how the bank has obtained said information. The "individual's relationship with the bank" that is covered by bank secrecy also includes relationships where an individual has negotiated with the bank regarding a potential customer relationship but for some reason never entered into one.

It should be noted that bank secrecy also covers a guarantor's relationship to a bank and any other relationship that results in the bank having information regarding the person in question and where there is a legitimate interest in keeping the information secret. Furthermore, bank secrecy does not cease if a customer relationship with the bank in question ends.

### Exceptions Permitting Disclosure

Bank secrecy is not absolute and there are situations where information may be disclosed. In some situations, the secrecy constitutes a duty not to spread information regarding the customer. On the other hand, there may be situations that oblige the bank to disclose the information. In addition, there may be situations where the bank is not obliged to, but instead has a right to derogate from the bank secrecy.

One example of where disclosure is permitted is when it is necessary in order to fulfil the customer's instructions. This may include disclosure internally, within the bank and where the bank has a legitimate interest to disclose the information. Such information can only be disclosed to the extent it is deemed necessary – ie, to the departments or to the group of persons where the information is needed in order to fulfil the customer's instructions.

To conclude, information regarding the bank's customers is not considered to be general or widely accessible within a bank. If the bank's employees gain access to customer information when such information is not required by the employee's duties and tasks, this would constitute a breach of bank secrecy.

A bank can be legally obliged to disclose customer information to authorities, such as the Swedish Tax Authority or the SFSA. Disclosure due to legal obligations is accordingly permissible.

Within a group of companies that includes a bank, there is often interest in having the information transferred within the group for marketing purposes. It can be argued that marketing constitutes a legitimate interest that would authorise the disclosure of customer information within the group, especially when the information is limited to the name and address of the customer and when the customer gets some kind of benefit in return, such as a discount on other services provided by the group.

To conclude, information regarding the customer can be used within the bank and under certain circumstances within a group of companies, but in no case can the information be used for interests that are in conflict with the customer's interests.

### Other Relevant Legislation

When processing information regarding the consumer, consideration must be given to other relevant legislation. For example, the processing of personal data must be compliant with the GDPR, which requires a legal basis and an explicit purpose for the processing.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

By the end of 2010, the Basel Committee published the first parts of the global regulatory framework called Basel III. The framework was finalised in late 2017, but parts of it were transposed in the EU through the CRR, which is directly applicable across the EU. Together with the CRD, these legal acts constitute the main legislative framework for banks in the EU and thus Sweden.

Sweden has implemented the CRD mainly through the Special Supervision Act, the CBA and the SFSA's regulations regarding prudential requirements and capital buffers (FFFS 2014:12) and regulations regarding the management of liquidity risks in credit institutions and investment firms (FFFS 2010:7). The regulations contain rules on consolidated situations, own funds, own fund requirements, large exposures, liquidity, reporting, disclosure of information, capital buffers and documentation of the undertakings' capital and liquidity assessment procedures. Sweden has made an exemption from the requirements set out in Article 129(1)(c) of the CRR to avoid the concentration problems on the Swedish market that could arise if issuers of covered bonds were referred to only a few derivative counterparties.

### Pillar 1 Requirements

According to capital adequacy requirements, Tier 1 and Tier 2 capital must exceed 8% of risk-weighted assets (Pillar 1 core requirements). The Tier 1 capital requirements include common equity and other qualifying financial instruments (so-called additional Tier 1 capital), the loss absorption capacity of which is considered equal to equity. The minimum requirement for common equity is 4.5% of risk-weighted assets, while the additional Tier 1 capital is 1.5%. On the other hand, Tier 2 capital is subordinated to unsecured senior debt of the bank and is set at 2%. Moreover, the CRR restricts accelerated repayments, redemptions and other cancellations of equity or debt made available to bank investors for Tier 1 and Tier 2. The CRR further restricts the granting of guarantees or security interests by subsidiaries of the bank in order to protect the quality of the bank's regulatory capital from dilution.

The 8% minimum capital requirement is fully binding for all banks; breach thereof could lead to a withdrawal of the bank's licence. However, capital buffer requirements result in much higher levels of capital for banks and especially for the global systemically banks (G-SII). A capital conservation buffer of 2.5% of risk-weighted assets is added to this. The total minimum common equity held as part of a bank's capital is therefore 7% of risk-weighted assets.

### Combined Buffer Requirements

Sweden prescribes the following capital buffer requirements:

- the capital conservation buffer;
- the institution-specific countercyclical capital buffer;
- the systematic risk buffer; and
- the buffers for systemically important institutions.

As mentioned above, the conservation buffer amounts to 2.5% and is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. The countercyclical buffer has a range between 0% and 2.5% of risk-weighted assets compromising common equity or other fully loss absorbing capital. The countercyclical buffer is utilised to address systemic risk concerns.

The SFSA has issued regulations regarding the calculation of the countercyclical buffer and the credit exposures' geographic composition. In accordance with the CBA, the SFSA shall set a countercyclical buffer guide and a countercyclical buffer rate each quarter. As of 9 September 2020, the buffer rate is set to 0% and the countercyclical buffer guide is set at 1.3%.

The purpose of the systemic risk buffer is to prevent systemic risks of a long-term, non-cyclical nature that are not covered by the CRR. The SFSA has imposed a systemic risk buffer of 3% on the larger banks in Sweden.

CBA provides for a surcharge for any G-SII between 1% and 3.5% of each bank's total risk-weighted assets. However, the limitation of 3.5% will be removed on 29 December 2020.

The SFSA is also responsible for identifying other systemically important institutions (O-SII) and deciding on additional capital buffer requirements for such institutions. As of 29 December 2020, the additional capital buffer for O-SII can amount to 3%. This capital buffer, however, is in addition to the systemic risk buffer.

#### Pillar 2 Requirements

Banks must identify, measure, govern, report internally and control their risks on a regular basis in order to ensure that the aggregated risk does not endanger their ability to meet their obligations. The banks must provide the SFSA with a documented internal capital adequacy assessment (ICAAP) for the SFSA to review and evaluate. Based on this evaluation, the SFSA can impose an additional individual requirement, which should cover risks that are not fully captured by the Pillar 1 requirements. This additional capital requirement is referred to as the "additional own funds requirement". The capital assessment further includes an assessment of the bank's need for a capital planning buffer, which should constitute a margin to the minimum requirement.

#### Liquidity Requirements

The CRR together with the delegated regulation and the SFSA's regulation FFFS 2010:7 prescribe the liquidity requirements for banks in Sweden. On a broad level, the focus areas for liquidity requirements are the liquidity coverage ratio (LCR) and – as of June 2021 – the net stable funding ratio (NSFR).

The LCR can be said to have two components:

- stock of high-quality liquid assets in stressed scenarios; and
- total net cash outflows.

Banks shall hold an adequate level of unencumbered, high-quality liquid assets that can be easily converted into cash at little or no loss of value to be able to cover the total net cash outflows over a 30 calendar day time horizon. When banks use the liquidity stock, they need to provide for a plan to restore their holdings of liquid assets, and the SFSA will need to ensure that such plan is adequate and sufficiently implemented.

The NSFR is defined as the amount of available stable funding relative to the amount of required stable funding. This requirement is meant to ensure that the banks have stable funding to cover long-term obligations under a one-year horizon under conditions of extended stress.

The FFFS 2010:7 prescribes requirements regarding internal governance, the identification and measurement of liquidity risks, the managing of liquidity risk and the disclosure of information. Banks shall have a documented risk tolerance that is based on a quantitative and qualitative view of appropriate liquidity risk and is adapted to the bank's operational objective, strategic direction and general risk preference. Furthermore, the bank shall have strategies in place to manage the liquidity risk in accordance with the risk tolerance in order to ensure sufficient liquidity.

In order for the SFSA to control compliance with these requirements, the banks are obliged to report the high-quality liquid assets at least every month to the SFSA and the stable funding at least quarterly to the SFSA.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

#### General

Sweden has implemented the Bank Recovery and Resolution Directive (2014/59/EU – the BRRD) through the Swedish Resolution Act. The BRRD in turn incorporates principles from the international standard "Key Attributes of Effective Resolution Regimes", issued by the Financial Stability Board (the FSB). Although it is an EU Member State, Sweden does not participate in the EU's SRM.

The purpose of the Resolution Act is to ensure that the government can take over a failing bank and restructure it or wind down its operations in an orderly manner to maintain the critical functions of the bank and stability in the financial system.

As of 2020, the resolution mechanism has never been put into practice in Sweden.

The basic principle in the resolution procedure is that the costs should be borne by the banks' shareholders and creditors (excluding protected depositors), and not the taxpayers. As a protection, another key principle is the "no-creditor-worse-off" principle, which means that no owner or creditor should be compensated to a lesser extent than he or she would have been under normal insolvency proceedings.

### Recovery and Crisis Planning

The NDO is the appointed Swedish resolution authority and, as such, is responsible for preparing for crises in banks and for managing banks in crises.

The NDO must prepare a crisis plan for all Swedish banks but the approach that the NDO will take varies depending on which bank is in crisis and what sort of crisis. In practice, only systematically important banks will be placed into resolution. Most banks are not considered systematically important, and the NDO has simplified plans for these banks. In general, these banks will be placed under ordinary insolvency proceedings if necessary.

Banks are required to prepare and maintain recovery plans, setting out the preventative measures and actions they will undertake if under financial distress in order to prevent failure. As the supervisory authority, the SFSA is responsible for assessing the recovery plans of banks, and may order a bank to improve the plan if necessary. The SFSA also has early intervention powers and may order banks to make organisational and strategical changes, to take recapitalisation measures or to activate the recovery plan.

### Requirements for Resolution

If actions taken under the bank's recovery plan or the intervention measures taken by the SFSA do not improve the bank's financial situation, the first step is to determine whether the bank is failing or is likely to fail. The SFSA will hand over the responsibility to the NDO if the following criteria are fulfilled:

- the bank infringes the requirements for continued authorisation in a way that justifies the withdrawal of its authorisation;
- its assets are less than its liabilities;
- the bank is unable to pay its debts as they fall due; and
- extraordinary public financial support is required (except when it concerns certain forms of precautionary support provided temporarily to fundamentally viable banks).

In order to initiate a resolution procedure, the NDO will also need to establish that there are no alternative measures available to prevent the failure of the bank, and that resolution is necessary with regard to the public interest. The public interest requirement is why non-systematically important banks in general will be placed in ordinary insolvency proceedings.

### Resolution Tools

Once a bank has been placed under resolution, the NDO will take over the control and management of the bank, but not any ownership. The NDO will have a number of "resolution tools" at its disposal, which are aligned with the BRRD and can be used separately or in combination.

These tools include the "bail-in tool", where shares and liabilities are written down or converted to equity. The writing down of shares will occur before debts are converted. The NDO might also sell all or parts of the shares issued by the bank, or its assets, rights or liabilities, to one or more buyers (the "sale of assets tool").

The "bridge institution tool" allows the NDO to transfer all or part of the bank's business to a separate legal entity controlled by the NDO, which will uphold critical functions until the business is sold or wound down. Under the "asset separation tool", assets that are non-critical for the functioning of the financial system can be separated from the bank and managed via an asset management vehicle.

### Resolution Reserve and Government Intervention

While the main principle is that shareholders and creditors should bear the bank's losses and the costs for resolution, there may sometimes be a need for external financing. For that purpose, a resolution reserve has been set up with the NDO.

The resolution reserve may be used as a complement to the bail-in tool, but only where the shareholders and creditors have already absorbed losses corresponding to 8% of the total assets or 20% of risk-weighted assets, and certain other criteria are fulfilled.

The resolution reserve is financed through annual fees, which banks must pay if their reserve is below 3% of their total covered deposits.

Finally, as a last resort, the government stabilisation tool may be used to recapitalise the bank or take temporary public ownership over it. This tool is separate from the use of the resolution reserve and may only be used after all other tools have been assessed and exploited to the maximum extent possible. This tool is subject to EU state aid rules and requires, inter alia, that a government makes the decision on whether the tool shall be used.

### Insolvency Preference Rules for Deposits

The depositor guarantee scheme (see **6.1 Depositor Protection Regime**) will apply regardless of whether resolution or ordinary bankruptcy proceedings are used. In bankruptcy, guaranteed deposits enjoy preference above unsecured and subordinated liabilities but below a number of secured liabilities, such as covered bonds.

### Precautionary Support to Sound Banks

It should be noted that the NDO may in some cases provide precautionary government support to systematically important banks that have temporary problems (eg, due to serious systematic disturbances in the economy) but that have sustainable finances on a long-term basis and a fundamentally sound business model. This is not an alternative to resolution under the Resolution Act and will not be provided to failing banks (as defined in the Resolution Act).

After the financial crisis of 2008, Sweden set up a "stability fund", to which the banks paid fees up to the establishment of the resolution reserve. Part of the stability fund was transferred to the resolution reserve but the remainder will finance such precautionary support measures.

# 10. Horizon Scanning

## 10.1 Regulatory Developments

On an EU level, amendments to the CRR, CRD and BRRD, among others, were adopted in 2019. These amendments are commonly referred to as the "package". With the package, certain parts of the final version of the Basel III agreement will be implemented – ie, requirements regarding more stable financing and a non-risk-weighted leverage ratio. The package further includes provisions that implement TLAC (Total Loss Absorbing Capacity) within the EU.

However, the COVID-19 pandemic is having a significant impact on the financial market. From a regulatory perspective, there has been a temporary easing of regulatory capital requirements and other prudential regulations, due to the current situation. For example, a "quick fix package" of the CRR, (EU) 2020/873 (CRR II), was adopted that, inter alia, extended the transitional arrangements for expected credit loss accounting under IFRS 9 and the treatment of publicly guaranteed loans under the prudential backstop for non-performing loans, offsetting the impact of excluding certain exposures from the calculation of the leverage ratio and deferring the application date for the leverage ratio buffer to 1 January 2023.

At a national level, banks in Sweden were given the possibility to offer all new and existing mortgagors an exemption from the amortisation requirements due to COVID-19. The exemption will be in force until the end of June 2021. Furthermore, the SFSA decided to lower the countercyclical buffer and communicated to the banks that they could use their liquidity buffers.

### CRD V/CRR II

The updated EU regulations entail several significant changes, with the key changes being outlined below.

#### *Leverage ratio*

One of the major changes is the binding leverage ratio that requires banks to maintain Tier 1 capital of at least 3% of their non-risk-weighted assets. An additional leverage ratio buffer will apply to G-SIIs. The CRR II also allows an initial margin to reduce the exposure measures when applying the leverage ratio to derivatives.

#### *Net stable funding ratio*

The CRR II introduces a net stable funding ratio (NSFR) that aligns with Basel III. The NSFR focuses on the liabilities side of the balance sheet as opposed to the liquidity coverage ratio, which focuses on the quality and liquidity of a bank's assets. The NSFR is designed to ensure that exposures are broadly matched with stable funding.

#### *Intermediate parent undertaking*

The CRD V contains a requirement to the effect that certain third country banks with subsidiaries within the EEA will have to establish an intermediate parent undertaking within the EEA. The requirement applies to groups that have at least two institutions within the EEA if the group's total assets within the EEA amount to EUR40 billion.

#### *Standardised approach for counterparty credit risk*

The CRR II introduces a new approach to counterparty credit risk (SA-CCR) which is more risk sensitive, providing better recognition of hedging, netting diversification and collateral.

#### *Remuneration*

As described under **4.3 Remuneration Requirements**, changes to remuneration rules under the CRD V as well as remuneration disclosure requirements under the CRR II will apply during the course of 2021.

#### *Sustainable finance*

The CRR II and the CRD V take steps towards a more sustainable future by prescribing some measures that focus on sustainable finance. EBA investigates how to incorporate Environmental, Social and Governance (ESG) risks into the supervision and treatment of assets associated with environmental and social objectives. Large banks are required to disclose their ESG-related risks.

#### *Bank crisis management framework*

The provisions regarding the subordination of minimum required eligible liabilities (MREL) instruments are tightened and a new category of large banks is introduced – the so-called "top-tier banks" with a balance sheet greater than EUR100 billion.

### *Group level requirements*
Certain requirements regarding core capital, large exposures, liquidity and reporting obligations prescribed in the CRR II will apply to holding companies.

### *Non-performing loans*
In relation to non-performing loans, the CRR II adjusts credit risk provisions to mitigate the capital impact of massive disposals of such loans.

A brief timeframe for the CRR II and CRD V is as follows:

- 28 December 2020: most of the CRD V requirements will have to be implemented;
- 21 June 2021: the CRR II will apply, with the exception of certain measures listed in Article 3, which have applied since 27 June 2019;
- 26 June 2021: the updated EBA guidelines on internal governance that capture the amendments under the CRD V are expected to enter into force;
- 28 June 2021: the CRR II will generally apply, although ESG disclosures will apply from 28 June 2022;
- 1 September 2021: the EBA implementing technical standards (ITS) on specific reporting requirements for market risk under Article 433b of the CRR will apply;
- 1 January 2022: the EBA final guidelines on credit risk mitigation for institutions applying the internal ratings-based (IRB) approach with own estimates of loss given default (LGD) will apply;
- 28 June 2022: the ESG disclosure requirements under the CRR II will apply; and
- the first or second quarter of 2023: the expected start date for the Internal Model Approach (IM) reporting requirements under the CRR II market risk standard will apply.

### BRRD2
The BRRD2 should be implemented on 28 December 2020. The BRRD2 includes updated minimum requirements for MREL, to align these with the FSB's TLAC standard. The CRR II contains important provisions implementing TLAC for G-SIIs. The BRRD2 further entails mandatory subordination as well as additional measures to address breaches of the MREL. The maximum distributable amount restrictions entail that capital buffer requirements are added on top of the MREL.

### Other Regulatory Changes and Updates
SRMR2, (EU) 2019/877, amends the SRM Regulation to reflect the BRRD2 amendments. Since Sweden is not participating in the banking union, this regulation is not applicable in Sweden. However, Sweden has just recently considered a potential participation but there are no decisions regarding participation as yet.

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**Advokatfirman Hammarskiöld & Co AB** is a leading Swedish business law firm and has developed a strong and recognised position in the banking and finance practice area. It represents a wide range of national and international clients in the financial industry. The practice covers all of the traditional and recently developed areas of banking and financing, such as asset finance, aircraft finance, secured and syndicated loan transactions and guarantees, as well as acquisition finance and bond issues. The firm is especially known for its financial regulatory practice, with notable expertise within all relevant areas of financial regulation, including credit institutions, investment firms, fund managers and payment institutions. Hammarskiöld handles regulatory compliance investigations and provides strategic regulatory advice to senior management in financial institutions. The firm is also experienced in handling matters with the Swedish Financial Supervisory Authority, including authorisations, market regulations, sanctions, and anti-money laundering requirements. The Banking & Finance team consists of three partners, two senior associates and five associates.

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# Trends and Developments

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## Sweden: Increased Household Indebtedness, Supervisory Challenges and New Business Opportunities

### *Introduction*

Household indebtedness in Sweden has risen continuously over the past few decades and is among the highest in the European Union. The growth rate in household debt has slowed down somewhat during the past few years but continues to be high, and the overall household debt stood at 176% of disposable income or 88% of GDP in 2019.

While the overall household debt consists primarily of mortgages, unsecured borrowing in the form of consumption loans and other forms of consumer credit have also accelerated over the past ten years. As a response, the Swedish legislator and the Swedish Financial Supervisory Authority (SFSA) have implemented a number of regulatory measures to halt this development.

This article will discuss the key drivers behind the development, the regulatory response and the challenges and opportunities faced by market participants. The regulatory development might have created some hurdles for market participants, but the Swedish credit market continues to expand. Sweden will likely continue to be an attractive market for domestic and foreign investors seeking to invest in Swedish loans.

### *Household debt in Sweden*

The increase in the Swedish household debt has been driven mainly by high mortgage lending linked to a steep increase in housing prices, primarily in urban areas. This continued increase in household debt has been identified by the Swedish Central Bank (*Riksbanken*) as the greatest risk to financial stability in Sweden. Several measures have been taken to address the issue, including strengthened amortisation requirements and increased capital buffer requirements for credit institutions. Changes to housing and tax policies have also been discussed on a political level to tackle structural problems in the housing market.

Consumer loans are currently considered to have limited implications in terms of financial stability risks. However, such loans constitute a risk for individual households, as they are often subject to high interest rates and fees. While they account for only a limited portion of the total indebtedness of Swedish households, the interest and amortisation payments for consumer loans stood for more than half of household debt payments in 2019. Therefore, the level of consumer loans could have an impact on the financial stability in the longer term, if the individuals are not paying off their loans and the debt level instead builds up over time. This may result in increased costs for the individual and decreased consumption. Because of this, consumer loans have been a key focus area for Swedish authorities in recent years.

### *Market participants*

Most of the loans in the Swedish market originate from credit institutions. In recent years, however, the traditional banks in Sweden have faced increasing competition from both niche banks and new types of market participants.

New technological solutions and regulatory developments have allowed fintech companies such as mortgage credit institutions and consumer credit institutions, which offer their services online, applying instant credit assessments and using digital tools for the quick processing of credit applications, to compete with traditional banks.

In connection with the Swedish implementation of the EU Mortgage Credit Directive 2014/17/EU, a new type of licence for mortgage credit institutions was introduced, resulting in specialised mortgage credit providers entering the market. The new licence enables financial undertakings to provide mortgage loans as their core business, with the increased use of alternative financing. While the loan volumes originated from mortgage credit institutions are still relatively small compared to those of the credit institutions, they continue to gain market shares and offer increasing competition through low interest rates and quick, digital credit application processes.

Consumer credit institutions are undertakings that provide or intermediate mainly unsecured consumer loans. Up until 2014, such businesses did not need to obtain a licence for their operations, but only needed to register with the SFSA. In order to address particular problems with so-called high-cost credits and to ensure sufficient supervision of these undertakings, consumer credit institutions are now required to obtain a licence from the SFSA.

Many consumer credit institutions and mortgage credit institutions do not originate their own loans but rather act as intermediaries that provide loan comparison platforms. These platforms have spurred the competition between credit providers and made Swedish consumers extremely prone to regularly transferring their existing loans and mortgages to the creditor that offers the lowest interest rates.

These new market participants are not allowed to take deposits from the public. Therefore, they must find alternative means to finance their loan origination – for example by attracting capital from pension trusts, insurance undertakings and other institutional investors.

Consumer credit institutions and mortgage credit institutions that wish to finance their business through deposits must apply for a licence as a credit institution. In recent years, however, it has become increasingly hard to obtain such a licence. The SFSA has only granted a few new licences and many have either been subject to non-approval or been voluntarily withdrawn by the applicant following the SFSA indicating that the application is unlikely to be approved. This could probably be explained, inter alia, by the development of a more comprehensive financial regulation and legislation and the enhanced supervisory measures taken by the SFSA over recent years. Nevertheless, this development has resulted in impressive hurdles for consumer credit institutions and mortgage credit institutions wishing to expand their business, making alternative financing solutions more and more relevant.

### *Consumer loans*

Sweden has implemented the EU Consumer Credit Directive (EU) 2008/48/EG (the CCD) through the Swedish Consumer Credit Act (the CCA), which sets out rules that must be complied with when credits are offered to consumers. While the CCD is a full-harmonisation directive, meaning that EU Member States may not impose stricter rules on matters within the scope of the directive, Sweden has implemented strict rules in areas outside the scope of the CCD. In contrast to the CCD, which excludes credit agreements involving a total amount of credit less than EUR200 from its scope, there are no monetary thresholds in the CCA for when the rules apply.

Consumer loans include unsecured loans, asset financing (eg, where a car serves as collateral), revolving credits and credit purchases. The increase in consumer loans has raised concerns with Swedish authorities, who are worried that more and more borrowers could face financial problems, particularly in the event of a general decline in the economy and increased unemployment.

As mentioned above, a significant part of the increase in consumer loans originates from undertakings that are not subject to the same prudential requirements as credit institutions. It has also become evident that the borrowers of these consumer credit institutions tend to fall into financial difficulties more often.

So far, regulatory actions to address problems associated with consumer loans have been focused on consumer protection, mainly to ensure that loans are provided on fair terms and that loans are not granted to individuals who lack the ability to service their loans.

### *High-cost credits*

So-called high-cost credits have caused particular concern in recent years. They are defined as credits with an effective interest rate equal to at least the reference rate plus 30 percentage points, and that are not connected to a credit purchase or mortgage loan.

In 2018, an interest rate ceiling and an absolute cost ceiling in relation to consumer credits were introduced to address the problems associated with high-cost credits. The maximum interest rate allowed is now the Central Bank of Sweden's reference rate plus 40%, and the maximum cost for a credit (including interest rates, late fees and other costs) may not exceed an amount equal to the original credit amount.

According to a report from the SFSA in October 2020, the total number of high-cost credits has been reduced and many of the institutions that previously provided such credits have now ceased to do so. Interestingly, the SFSA also reported that consumers now borrowed nearly 7% more after the legislation entered into force. This indicates that the regulatory intervention to reduce high interest rate levels also resulted in increased borrowing.

### *Credit assessments and an increasing number of small loans*

As a general rule, all credit agreements must be preceded by a credit assessment in order to determine the customer's ability to repay the credit. According to the CCA, a credit assessment must be based on sufficient information regarding the customer's financial situation. The credit may be granted only where the consumer's financial situation is such that he or she will be able to repay the loan. Furthermore, a credit assessment does not always need to be conducted. According to the CCA, the institutions are not obligated to conduct a credit assessment under certain circumstances – ie, if the credit is interest-free, concerns a credit purchase that has to be repaid within three months and only entails an insignificant fee.

However, poor credit assessments are becoming a focus area of the authorities. A 2020 report from the SFSA showed that a fifth of consumer loan borrowers received payment reminders and 4.5% received collection notices, rising to 8% among borrowers under the age of 25.

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The report also showed that larger loans are more often preceded by a more comprehensive credit assessment than smaller loans. Smaller loans (ie, loan amounts under SEK10,000) have increased from SEK4 billion in 2008 to nearly SEK50 billion 2019. Therefore, a significant amount of credit granted to consumers is based on a more simplified credit assessment.

Against this background, the SFSA has stressed the importance of performing proper credit assessments on each customer, and announced its intention to issue new guidelines on the information that credit institutions should use in credit assessments during 2021. The Swedish Consumer Agency (*Konsumentverket*), which supervises the credit assessments of consumer credit institutions (but not those of the credit institutions), has also recently issued updated guidelines in relation to credit assessments, which state that information regarding the customer's monthly salary, expenditure, credits and instalments should be obtained in order to assess the customer's financial situation. The information should further be verified by, for example, external sources.

The large increase in smaller loans, where only a limited credit assessment is carried out, can to a large extent be explained by the fact that "buy-now, pay-later" alternatives have largely increased the number of credit purchases made online. A growing number of consumers have ended up in debt when they have become unable to repay such credits.

### *Presentation of credit as a payment option*

In order to tackle the increasing number of consumers ending up in debt in connection to their online purchases, an amendment to the Swedish Payment Services Act (2010:751) entered into force in July 2020. The amendment means that payment options including a credit element may no longer be automatically displayed over other available payment options or as a default option in connection with online purchases. However, the effectiveness of the new legislation has been called into question, as credit providers have already found ways around the rules – eg, by arguing that it is not technically possible to distinguish between debit cards and credit cards.

### *Marketing of consumer loans*

The marketing of credits to consumers is governed by the CCA. In 2018, a new provision was introduced in the CCA, which explicitly states that the marketing of consumer credits must be moderate. The purpose was to further emphasise that marketing must be made with consideration of the general risks associated with consumer credits, such as over-indebtedness, and to prevent consumers from making unconsidered decisions. The requirement that marketing must be moderate entails, inter alia, that it must not depict consumer credits as a carefree solution to economic problems. In a recent court case, a credit provider was prohibited under the risk of a penalty fine from continuing to depict its services as a carefree solution to economic problems by stating that consumers can obtain a happier lifestyle by using loans.

The Consumer Agency, which is the authority responsible for supervising marketing practices in Sweden, has increased its scrutiny of credit providers in recent years. The Consumer Agency has the authority to file a cease and desist order under a penalty if a breach is considered to be of minor importance, or to file a lawsuit before the Patent and Market Court (*Patent- och Marknadsdomstolen*).

### *Mortgage loans*

As mentioned above, the Swedish legislator and the SFSA have also adopted measures aimed at slowing down the increase in mortgage-to-income ratios.

In order to prevent over-indebtedness and overvalued house prices, the Swedish Government introduced an amortisation requirement for mortgage loans in 2016. The amortisation requirement is supplemented by SFSA regulations, which provide further detailed rules and requirements in relation to amortisation and the maximum amount of mortgage loan a consumer may be granted.

Depending on the loan to valuation ratio and the borrower's debt ratio, the borrower must amortise up to 3% of the mortgage loan per year. Furthermore, according to the SFSA's regulations, a mortgage loan may not be granted if the loan to valuation ratio exceeds 85%. The requirement applies to credit institutions as well as mortgage credit institutions. However, the new amortisation requirement has been subject to criticism – eg, since entry into the mortgage market for younger people with lower incomes is now even more difficult.

Due to the COVID-19 pandemic, credit institutions in Sweden were given the possibility to offer all new and existing mortgagors an exemption from the amortisation requirements. The exemption will be in force until the end of June 2021.

### *Conclusions*

Sweden stands out among several of the EU countries when it comes to the high levels of household debt. Although the household debt in Sweden consists primarily of mortgages, unsecured consumer loans have also increased over the last decade. The low interest rate environment will most probably cater for further expansion of the credit market in the short and medium term.

Even though parts of the Swedish regulations are based on EU directives, Sweden has taken regulatory measures on a national level to address certain identified issues related to consumer loans and mortgage loans. The regulatory measures taken include the introduction of maximum interest rates and absolute cost ceilings for high-cost credits, authorisation for consumer credit providers, enhanced supervision regarding the marketing of credit products, the focus on sufficient credit assessments, and the amortisation requirements for mortgage loans. The SFSA has also adopted a stricter approach when assessing and approving credit institution licence applications, making it difficult for consumer credit institutions and mortgage credit institutions to expand their business.

For credit providers, the challenge will be to find ways to grow their business, as margins are low in a market where they are subject to fierce competition. In their quest to find ways to finance their expansion this may lead to a development when faced with difficulties obtaining authorisation as a credit institution, where new financing models are actively sought. This may create business opportunities for service providers and intermediaries that can enable innovative structured financing solutions. Such solutions could offer a level of yield that may be attractive as an investment for institutional investors, including alternative investment funds, insurance undertakings and pension trusts. There are several developments in this area, where new financing solutions are made available to credit providers.

However, it is important for market participants to be aware of the regulatory developments, particularly regarding consumer and mortgage loans that will continue to be an area of focus for the Swedish Government and the SFSA.

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**Advokatfirman Hammarskiöld & Co AB** is a leading Swedish business law firm and has developed a strong and recognised position in the banking and finance practice area. It represents a wide range of national and international clients in the financial industry. The practice covers all of the traditional and recently developed areas of banking and financing, such as asset finance, aircraft finance, secured and syndicated loan transactions and guarantees, as well as acquisition finance and bond issues. The firm is especially known for its financial regulatory practice, with notable expertise within all relevant areas of financial regulation, including credit institutions, investment firms, fund managers and payment institutions. Hammarskiöld handles regulatory compliance investigations and provides strategic regulatory advice to senior management in financial institutions. The firm is also experienced in handling matters with the Swedish Financial Supervisory Authority, including authorisations, market regulations, sanctions, and anti-money laundering requirements. The Banking & Finance team consists of three partners, two senior associates and five associates.

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HAMMARSKIÖLD

# SWITZERLAND

## Law and Practice


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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### FINMA as Regulator of the Banking Sector

Swiss Banks and Swiss branch offices or representative offices of foreign banks are subject to prudential supervision by the Swiss Financial Market Supervisory Authority (FINMA).

### Principal Laws and Regulations for Banks

The Swiss Federal Banking Act of 8 November 1934 (Banking Act) and the ordinances issued under the Banking Act are the relevant pieces of legislation governing banks under Swiss law.

The key ordinances under the Banking Act include:

- the Swiss Federal Banking Ordinance of 30 April 2014 (Banking Ordinance);
- the Capital Adequacy Ordinance of 1 June 2012 (Capital Adequacy Ordinance), covering the rules on capital requirements for all banks and securities firms, including banks of systemic importance;
- the FINMA Ordinance on the insolvency of banks and securities firms of 30 August 2012 (BIO-FINMA);
- the Ordinance on the liquidity of banks and securities firms of 30 November 2012 (Liquidity Ordinance);
- the Ordinance on foreign banks in Switzerland of 21 October 1996 (Foreign Banks Ordinance); and
- the FINMA Ordinance on accounting rules of 31 October 2019 (the FINMA Accounting Ordinance).

FINMA issues circulars on various topics, specifying its supervisory practice (see https://finma.ch/en/documentation/circulars/). In addition, various self-regulatory organisations (in particular the Swiss Banking Association – SBA) issue regulations that affect the banking business (eg, the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence – CDB 20: www.swissbanking.org/en/services/library/guidelines?set_language=en).

### Further Relevant Laws and Regulations for the Banking Sector

Other laws and regulations that are most relevant for the banking sector include:

- the Swiss Financial Market Supervisory Act of 22 June 2007 (FINMAA), including the competences of FINMA to proceed with enforcement actions and issue sanctions in respect of firms subject to FINMA supervision;
- the Swiss National Bank Act of 3 October 2003 (NBA) and the ordinance thereto of 18 March 2004 (NBO) setting out the regulatory framework for the Swiss National Bank (SNB) and its powers;
- the Swiss Financial Institutions Act of 15 June 2018 (FinIA) and the ordinance thereto of 6 November 2019 (FinIO) including the rules on the prudential supervision of securities firms, asset managers, asset managers of collective investment schemes, fund management companies and trustees, as well as the licensing requirements for foreign financial institutions (other than banks) with a Swiss branch of representative office;
- the Swiss Financial Services Act of 15 June 2018 (FinSA) and the ordinance thereto of 6 November 2019 (FinSO) including the rules of conduct for financial services providers, the organisational requirements for financial services providers, registration requirements for financial services providers not subject to prudential supervision in Switzerland, the obligation to adhere to an ombudsman service for financial services providers not only interacting with professional or institutional clients and the primary market rules for securities offerings;
- the Swiss Financial Market Infrastructure Act of 19 June 2015 (FMIA) and the ordinance thereto of 25 November 2015 (FMIO) including the rules governing financial market infrastructure (including trading venues for securities, central counterparties, central securities depositories and payment systems), the rules of conduct for dealing in OTC derivatives and exchange-traded derivatives, rules on the disclosure of significant shareholders in listed companies and the rules on market abuse and insider dealing;
- the Swiss Federal Act on Combating Money Laundering and Terrorist Financing of 10 October 1997 (AMLA) and the ordinance thereto of 11 November 2015 (AMLO); and
- the FINMA Ordinance on Combating Money Laundering and Terrorist Financing of 3 June 2015 (AMLO-FINMA) including the rules on implementing the AML framework by FINMA-regulated financial institutions.

# 2. Authorisation

## 2.1 Licences and Application Process

### Types of Licences

A bank incorporated in Switzerland can apply for the following types of licence:

- a full banking licence in the sense of article 1a of the Swiss Banking Act (Bank Licence); and
- a bank licence in the sense of article 1b of the Swiss Banking Act (FinTech Licence).

Foreign banks can apply for the following types of licence, depending on the type of activity conducted in Switzerland:

- a licence as a Swiss branch of a foreign bank duly licensed and supervised in its place of incorporation, if it operates an office in Switzerland that enters into transactions, maintains client accounts or commits the bank legally (Swiss Branch Licence); or
- a licence as a representative office of a foreign bank duly licensed and supervised in its place of incorporation, if it operates in another way in or from Switzerland – eg, by passing on client orders to the foreign bank or representing it for advertising or other purposes (Swiss Representative Office Licence).

However, where a foreign bank does not have a presence in Switzerland and does not engage in the activity of an introducing broker in Switzerland as regards transactions in securities, please note that an inbound cross-border activity alone is currently not subject to a licensing requirement, provided the foreign bank registers front-office staff dealing with retail clients in Switzerland with a registration body for client advisers in the sense of article 28 et seq FinSA. Such registration requirement is not a licensing requirement.

### Categories of Banks

Depending on the balance sheet total, the assets under management, the deposits subject to a depositor protection scheme and the own funds, FINMA classifies banks into the categories 1 to 5, with category 1 being the largest banks requiring most attention by the regulator. The category allocated to each bank is published on https://finma.ch/de/finma-public/bewilligte-institute-personen-und-produkte/.

In addition to such categorisation, FINMA and the SNB are mandated to identify Swiss banks of systemic importance for the Swiss market, in terms of size, interconnectedness with the financial system and the economy, and the short-term substitutability of the services provided by the bank. In making this assessment, particular attention must be paid to the importance of the deposit and lending business, the importance of the payment transaction business, the amount of secured deposits, the ratio between the balance sheet total and the annual Swiss gross domestic product and the risk profile of the bank (article 8 para. 2 Banking Act). Initially, only UBS and Credit Suisse were classified as systemically important banks (SIBs), but the Zurich Cantonal Bank, Raiffeisen and Postfinance have since been added.

On the other end of the scale, Swiss banks categorised by FINMA in categories 4 or 5 may opt-in to a "small banks regime" if they have own funds resulting in a simplified leverage ratio of at least 8% (calculated as the CET1 capital divided by the total balance sheet without the goodwill, participations and off-balance sheet positions), an average liquidity ratio of at least 110% and a refinancing ratio of at least 100% (calculated as the ratio of (i) the liabilities resulting from deposits, money market obligations, debt obligations and covered bonds with a remaining term of more than one year and own funds divided by (ii) the claims against clients and counterparties, including claims resulting from mortgage lending). These thresholds must be met on an entity and group-wide level. If FINMA agrees to grant such "small bank" status, the own funds requirements are not calculated according to the minimum requirements that would otherwise apply pursuant to articles 41-46 of the Capital Adequacy Ordinance.

### Activities and Services Covered by a Bank Licence

The following activities trigger a Bank Licence requirement:

- accepting, or offering to accept, deposits from 20 or more persons or companies on an ongoing basis, provided that this calculation would not take into account any deposits received from:
  - (a) banks or other companies subject to prudential supervision;
  - (b) shareholders holding at least 10% of the voting rights or the capital and affiliates thereof or persons related to such shareholders;
  - (c) institutional investors with professional treasury operations;
  - (d) employees or former employees; and
  - (e) persons benefiting from a guarantee by a bank licensed by FINMA; and
- providing financing to an unlimited number of unaffiliated persons or companies (provided that this activity shall be refinanced by unaffiliated banks).

For these purposes, deposits would include any liabilities except the following:

- deposits held by securities or precious metal traders, asset managers or similar businesses (but not by a "currency trader") in settlement accounts for their clients, provided that such settlement accounts are exclusively used for the execution of client transactions that will occur in the foreseeable future, the settlement accounts are not interest-bearing and the funds are on-transferred within a maximum period of 60 days (such maximum time period does not apply to deposits held with securities traders);
- funds paid as consideration for goods or services;
- bonds and other fungible debt obligations issued on the basis of offering documentation, including certain minimum information specified in the Banking Ordinance;
- funds up to CHF3,000 pre-paid to a payment solution in view of a future use for the payment as consideration for goods or services, provided that no interest is paid on such funds;

- funds guaranteed by a Swiss bank; and
- funds paid on a life insurance or social security plan.

A "sandbox" exemption allows a deposit-taking activity without triggering a banking licence if the deposits are below CHF1 million and are not re-invested with the aim of generating a profit, and if the depositors are informed that the entity is not licensed as a bank and that they do not benefit from a depositor protection scheme.

According to article 6 FinIA, and because the Bank Licence is the "highest status" in the hierarchy of FINMA licences, an entity licensed as a Swiss bank may conduct the regulated activities of the following:

- a securities firm;
- an asset manager of collective investment schemes;
- an asset manager of assets not held in a collective investment scheme; and
- a trustee.

### Activities and Services Covered by a FinTech Licence

The FinTech Licence is applicable to companies that accept deposits from the public up to a maximum of CHF100 million, provided that such deposits are not reinvested and not interest bearing. FINMA may increase the CHF100 million threshold in particular cases if customers are adequately protected. Furthermore, the FinTech Bank Licence requires that investors are informed in advance about the business model, the services provided and the risks associated with the technologies used, that the deposits are not covered by a deposit protection system and that there is no immediate reimbursement in case of bankruptcy.

The accepted deposits must be held separately from the company's own funds. The deposits have to be held in the currency they were made as sight deposits or as highly liquid assets. Deposits in the form of crypto-assets have to be held in the same type of crypto-assets (same cryptocurrency or same tokens) as they were accepted from the clients.

### Conditions for Licensing of Swiss Banks with a Bank Licence

FINMA requires Swiss banks to meet the following licensing conditions.

- Legal form: with the exception of the cantonal banks that are established as public entities or joint stock corporations under the relevant legislation of the Canton pursuant to article 3a Banking Act, the Banking Act does not provide for any special rules regarding the legal form of banks.
- Minimum capital: the bank must have a fully paid-up minimum capital of CHF10 million (article 3 para. 2 lit. b Banking Act and article 15 Banking Ordinance).
- Business activity description: in accordance with article 3 para. 2 lit. a Banking Act and article 9 of the Banking Ordinance, the bank is obliged to precisely define its business area in the articles of association and organisational regulations in terms of subject matter and area of operation. The scope of tasks and geographical area of operation must be aligned with the financial possibilities and the administrative organisation.
- Organisation: article 3 para. 2 lit. a Banking Act requires that separate bodies must be set up for management and for the supervision and control of at least three members. According to article 11 of the Banking Ordinance, no member of the body responsible for the overall supervision and control may be a member of the management. In accordance with article 12 of the Banking Ordinance, the bank must also ensure an internal separation of functions between trading, asset management and settlement.
- Internal controls: the bank must set up an internal control system and appoint an "internal audit" function that is independent from the management in addition to appointing external auditors (see **4.1 Corporate Governance Requirements**).
- Fit and proper requirements: members of the management and the material shareholders (ie, shareholders holding at least 10% of the capital or voting rights) must meet the relevant fit and proper requirements (see **4.2 Registration and Oversight of Senior Management**).
- Operation in Switzerland: the bank must be managed in Switzerland with the management being present in Switzerland.
- Foreign controlled banks: if a foreign shareholder holds at least 50% of the capital or voting rights or otherwise exercises control, FINMA may require that the relevant jurisdiction grants reciprocity (see **3.1 Requirements for Acquiring or Increasing Control over a Bank**).
- Consolidated supervision: if the bank is part of a foreign-controlled financial group, FINMA may require that it is subject to appropriate consolidated supervision by foreign supervisory authorities (article 3b Banking Act), and the licence may be subject to the approval of the relevant foreign supervisory authority. Not all jurisdictions meet the requirement of "adequate consolidated supervision" within the meaning of the Banking Act.

### Conditions for Licensing of Swiss Banks with a FinTech Licence

FINMA requires Swiss banks with a FinTech Licence to meet the following licensing requirements.

- Legal form: it must be established as a joint stock corporation (*Aktiengesellschaft*), a partnership limited by shares (*Kommanditaktiengesellschaft*) or a limited liability company (*Gesellschaft mit beschränkter Haftung*).
- Minimum capital: the bank must have a fully paid-up minimum capital of at least 3% of the deposits it has taken; such capital must be at least CHF300,000 (article 17a Banking Ordinance).
- Business activity description: the bank is obliged to precisely define its business area in the articles of association and organisational regulations in terms of subject matter and area of operation. The scope of tasks and geographical area of operation must be aligned with the financial possibilities and the administrative organisation (article 14b Banking Ordinance).
- Organisation: separate bodies must be set up for management and for the supervision and control of at least three members. According to article 14d para. 2 of the Banking Ordinance, at least a third of the members of the body responsible for the overall supervision and control must be independent from the management.
- Internal controls: the bank must set up an internal control system and appoint an "internal audit" function that is independent from the management, in addition to appointing external auditors.
- Fit and proper requirements: members of the management and the material shareholders (ie, shareholders holding at least 10% of the capital or voting rights) must meet the relevant fit and proper requirements.
- Operation in Switzerland: the bank must be managed in Switzerland with the management being present in Switzerland (article 14c Banking Act).

#### Conditions for Licensing Foreign Banks

As regards a Branch Office Licence and a Representative Office Licence, the relevant requirements set out in the Foreign Bank Ordinance must be met.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

#### Duty to Notify FINMA

Any natural or legal person that intends to hold, or to cease to hold a qualified participation in a bank, directly or indirectly, is required to notify FINMA in advance. A qualified participation exists if a natural person or legal entity holds directly or indirectly at least 10% of the capital or the voting rights of a bank, or can otherwise exercise significant influence over the management of the bank. The duty to notify also applies to the holder of a participation who intends to increase or decrease that participation above or below the thresholds of 10%, 20%, 33% and 50%. The bank must report to FINMA any person who is acquiring or selling a qualified participation or whose participation increases or decreases below the thresholds of 10%, 20%, 33% and 50%. The bank must update its list of qualified participants at least once a year.

#### Proper Business Conduct Requirement

Any person who intends to hold a qualified participation in a bank must guarantee that the influence to be acquired will not be used in a way that is detrimental to the prudent and proper management of the bank. To assess compliance with the proper business conduct requirement, FINMA must be provided with certain indications and documents, as set forth in article 8 of the Banking Ordinance. In addition, any person acquiring a qualified participation must indicate whether the participation is acquired for own account or on a fiduciary basis, and whether any options or similar rights will be granted on the participation.

#### Banks under Foreign Control

If a Swiss-controlled bank passes under foreign control as a result of the acquisition of the participation, it must require an additional licence from FINMA. A new additional licence is also required in case of any change in a qualified participation held by a foreigner in a foreign-controlled bank. A bank is under foreign control if foreigners holding qualified participations directly or indirectly hold more than half of the voting rights, or if the bank is controlled in any other way by foreigners. A "foreigner" is either a physical person who has neither Swiss nationality nor a type C Swiss residence permit, or a legal entity whose registered office is located abroad or that is controlled directly or indirectly by foreigners.

The granting of the additional licence is subject to the following conditions:

- reciprocity must be guaranteed by the countries in which the foreigners holding their qualified participation have their domicile or registered office (however, reciprocity does not need to be verified in the case of contradictory provisions in international agreements, such as vis-à-vis the member states of the World Trade Organization);
- the bank's corporate name must not indicate or suggest a Swiss character of the bank; and
- if the bank becomes part of a financial group or financial conglomerate, FINMA may make the granting of the additional licence dependent on the approval of the transaction by the competent foreign supervisory authority and appropriate consolidated supervision.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Overview

Banks must comply with specific corporate governance requirements defined in the banking legislation, particularly the Banking Act and the Banking Ordinance, as well as in various FINMA circulars, particularly FINMA Circular 2017/1 "Corporate governance – banks" and, to the extent applicable, with the general corporate governance requirements set forth in Swiss corporate law.

### Board of Directors

The board of directors of the bank must be comprised of at least three members. A third of the board members must be independent and none of them is allowed to be part of the bank's executive management, unless FINMA agrees to grant an exception. Banks in supervisory categories 1 to 3 must establish an audit committee and a risk committee (these committees may be combined into a single committee in banks assigned to the supervisory category 3). The audit and risk committees must be comprised of a majority of independent board members. The chairman of the board of directors cannot be a member of these committees. In addition, systemically important institutions must establish a compensation and nomination committee, at least at group level.

The board of directors is the governing body for the guidance, supervision and control of the institution. It has specific duties regarding the bank's business strategy and risk policy, organisation, financial situation, and personnel and resources, as well as the monitoring and control of the executive management, and is responsible for taking decisions on major structural changes and investments.

### Executive Management

The executive management is responsible for conducting the operational business activities of the bank in accordance with the strategy, targets and internal regulations set forth by the board of directors. It has specific duties and responsibilities in terms of financial and risk management, representation of the institution towards third parties, the transmission of information to the board of directors, and the establishment of effective internal processes, including an appropriate management information system, an internal control system and the necessary technological infrastructure.

### Risk Management Framework and Internal Control System

Banks must adopt and maintain an institution-wide risk management framework that defines their risk policy and risk tolerance as well as the corresponding risk limits in all key risk categories, in addition to an internal control system comprised of two controlling bodies: the revenue-generating units and the independent control bodies (risk control and compliance functions).

### Internal Audit

Banks must have an internal audit function, in addition to their regulatory audit firm. The internal audit function can be internalised or delegated, inter alia, to the internal audit of a group company if certain requirements are met or to an external audit firm that is independent from the bank's regulatory audit firm. The internal audit function reports directly to the board of directors and has an unlimited right of inspection, information and audit within the institution in the context of its duties.

### Other Organisational Requirements

Banks face numerous other organisational requirements, depending on the type of activities conducted.

## 4.2 Registration and Oversight of Senior Management

### Board of Directors

The board of directors must have adequate management expertise and specialist knowledge and experience of the banking and financial services sector. It must be sufficiently diversified so that all key aspects of the business are adequately represented, including finance, accounting and risk management. Board members are appointed by the shareholders' meeting (if the bank is organised in the form of a joint stock company).

The board of directors must define the requirements for its members, the chairman, and the members of its sub-committees. The board of directors must critically assess its performance at least once a year and must record the results in writing.

### Executive Management

Members of the executive management, both individually and as an overall body, must have adequate management expertise and the specialist knowledge and experience of banking and financial services required to ensure compliance with licensing requirements in the context of the bank's operational activities. They are appointed by the board of directors, which must also appoint the chief risk officer and the head of internal audit. The requirements for the chief executive officer are defined by the board of directors, which also approves and periodically reviews the requirements for the other members of the executive management, the chief risk officer and the head of internal audit.

### Good Reputation and Proper Business Conduct

Each member of the board of directors and executive management must maintain a good reputation and fulfil the requirement of proper business conduct ("fit and proper" requirements). Any change in the board of directors or the executive management must be notified to and approved by FINMA in advance of such change occurring. The information and documents to be provided to FINMA are set out in article 8 of the Banking Ordinance and the relevant FINMA guidelines. Members of the executive management must have their domicile in a place that allows them to perform their tasks in an effective and responsible manner.

### 4.3 Remuneration Requirements

**Compensation System for Independent Control Bodies**

As a general rule, the compensation system for the members of the independent control bodies and the internal audit function must not create incentives that could lead to conflicts of interest with the duties of these bodies or function.

**FINMA Circular 2010/1**

FINMA has adopted Circular 2010/1 "Remuneration schemes", defining the minimum standards for the design, implementation and disclosure of remuneration schemes in financial institutions. It defines the various principles that must be reflected in the bank's remuneration policy, including that the structure and level of total remuneration must be designed so as to enhance risk awareness, and that variable remuneration must be funded through the long-term economic performance of the bank and shall depend on sustainable and justifiable criteria reflecting the bank's business and risk policies.

However, this circular only applies to banks that are required to maintain equity capital of at least CHF10 billion, either in their capacity as a single entity or at the financial group or conglomerate level. All other banks are recommended to follow its principles as best practice guidelines.

**Specific Provisions for Systematically Important Banks and Listed Companies**

The Banking Act provides for the right of the Swiss Federal Council to impose measures relating to remuneration packages of employees of systematically important banks or their group company if they receive state aid from federal funds.

Finally, if the bank is a listed company, it must follow the remuneration requirements applicable to listed companies, particularly those set forth in the Ordinance against Excessive Remuneration in Listed Companies Limited by Shares.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

The AMLO-FINMA specifies the general provisions in the AMLA and sets out how Swiss banks must implement the obligations to combat money laundering and terrorist financing. As regards the requirements for the identification of the contracting parties and the determination of the beneficial owner of assets, AMLO-FINMA refers to the provisions of the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence of 3 June 2018 (CDB 20).

Swiss banks must identify natural persons by an official identification document with a photograph. In the case of legal entities and partnerships, the identification of the contracting party generally takes place by means of an official register extract. Banks must further record the means by which the identity has been verified, and put a copy of the correspondent identification documents on record. A business relationship can be established in person, by correspondence or via the internet (in accordance with the applicable FINMA Circular 2016/7 Video and online identification of 3 March 2016).

The contracting party of a Swiss bank is required to declare the beneficial owner (natural person) of the assets. The beneficial owner of an operating legal entity is defined as the natural person who ultimately controls the legal entity (controlling person). The contracting party must record the information of the beneficial owner or controlling person by means of a written declaration or specific form as provided by CDB 20.

According to the AMLO-FINMA, among others, details of payment transactions must be indicated, the reasons for using domiciliary companies must be clarified, and criteria for identifying business relationships or transactions with increased risks must be developed. In the case of business relationships or transactions with increased risks, Swiss banks are required to make additional clarifications.

Swiss banks shall prepare documentary evidence of the transactions carried out and the clarifications required, and shall ensure adequate training of staff and controls.

Swiss banks must immediately report the following to the Money Laundering Reporting Office (MROS):

- if they know or have reasonable grounds to suspect that the assets involved in the business relationship are connected with money laundering or criminal organisations, derive from a crime or a qualified tax offence, or serve to finance terrorism;
- if they terminate negotiations for the establishment of a business relationship on reasonable suspicion in accordance with the above; or
- if they know or have reason to suspect, on the basis of the investigations carried out, that the data of a person or organisation forwarded by a supervisory authority or organisation

corresponds to the data of a person of their own business relationships or transactions.

Swiss banks must block the assets entrusted to them as soon as MROS informs them that it will forward their report under (a) to a prosecution authority, but must immediately block any assets that are connected with a report under (c). Swiss banks may not inform either the person concerned or third parties that they have made a report to MROS.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

In Switzerland, clients' deposits are protected by both the depositor protection scheme and the preferential treatment granted in the event of a bank's bankruptcy. Deposits totalling CHF100,000 per client are regarded as privileged deposits.

In essence, depositor protection is based on a three-tiered system.

- First, privileged deposits are immediately paid out from the remaining liquidity of the failed bank. FINMA determines the maximum amount of deposits payable immediately. As a result, the largest possible number of retail clients will be paid out before bankruptcy proceedings are instituted.
- Secondly, if the bank's available liquidity fails to cover all privileged bank deposits, the depositor protection scheme is used to pay out privileged deposits, provided that they were booked in Switzerland (so-called secured deposits). All banks in Switzerland that accept client deposits are obliged to participate in the depositor protection scheme. When FINMA has declared bankruptcy, it notifies the depositor protection scheme and informs it about the liquidity required to pay out the secured deposits. The funds required are provided to FINMA or its agent by the other members of the association, up to a maximum amount of CHF6 billion within a period of 20 days. The association members are legally required to keep half of the amount that they are obliged to contribute as additional liquidity. As an additional measure towards achieving full payment of all privileged deposits at the latest during bankruptcy proceedings, such deposits are underpinned with domestically held assets, which FINMA can easily access.
- Thirdly, privileged deposits are treated preferentially and are paid out at the same time as other second creditor class claims in the event of bankruptcy – ie, once first-class claims such as employee salary and pension fund claims have been paid out.

Unlike cash deposits in bank accounts, assets such as shares, units in collective investment schemes and other securities held in custodial accounts are client property, and are ring-fenced in their entirety and released to clients in the event of bankruptcy.

Deposits with pension and vested benefits foundations, particularly vested benefits accounts and pillar 3a pension funds, are privileged separately up to a maximum of CHF100,000 per client. However, these deposits are not part of the depositor protection scheme and are only paid out during the bankruptcy proceedings through the pension fund. In the event of bankruptcy, client deposits and pension savings of over CHF100,000 per client are regarded as third creditor class claims and are treated equally with the claims of other creditors.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

The Banking Act is the primary law governing bank secrecy in Switzerland, article 47 of which states that anyone who, intentionally or in negligence, discloses confidential data that has been entrusted to him or her in his or her capacity as a member of an executive or supervisory body, employee, representative, or liquidator of a bank, or that he or she has learned when exercising his or her profession, is liable to prosecution. Swiss banks also have a civil law obligation to respect the confidentiality of customer data, arising out of the customer's right to personal privacy and the contractual relationship between the customer and the bank.

The definition of confidential information is broad, and includes information on the customer as a private individual, on deposits and withdrawals, on loans, investments, the customer's financial circumstances, etc. However, the Banking Act only protects information related to an identified or identifiable customer, so customer data may be disclosed by, for example, anonymising the customer name, account number or other identifying information, or by aggregating customer data.

Several exceptions allow a bank to disclose customer data protected by the banking secrecy obligation, including:

- disclosure of customer data when requested under a Swiss statute requiring disclosure of such information to a government authority;
- disclosure to a parent company that is supervised by a banking or financial market supervisory authority if the disclosure is necessary for consolidated supervision purposes, subject to certain conditions;
- disclosure of customer data in cases of an overriding private or public interest; and

- disclosure of customer data to comply with agreements Switzerland has entered into with other countries (such as the OECD Model Tax Convention, the Agreement on the Automatic Exchange of Information (AEOI), or the Agreement between the USA and Switzerland for Cooperation to Facilitate the Implementation of FATCA).

In addition, in the account opening documents (including the general terms and conditions), banks typically obtain customer consent for disclosures not permitted under the Banking Act. For this purpose, banks need to clearly define the scope of consent, as a general waiver of bank secrecy is not sufficient.

On 26 March 2019, the SBA published its guidelines for the secure use of cloud services in banking (SBA Guidelines), according to which the deployment of customer identifying data (CID) to a cloud provider outside Switzerland does not constitute a breach of banking secrecy, subject to a number of specifically defined technical (eg, anonymisation, pseudonymisation or encryption, etc), organisational (eg, monitoring and auditing) and contractual (eg, specification of the proceeding in the event of requests by foreign authorities, securing the auditability at all times, definition of an access concept, etc) security measures as generally set out in the SBA Guidelines. As far as is known, the SBA Guidelines have not been endorsed by FINMA, so the risk of migrating to the cloud remains with the individual banking institutions.

In addition to the Banking Act, the Federal Act on Data Protection of 19 June 1992 (FADP) and its implementing ordinance apply to the processing of personal data pertaining to individuals and legal persons. The FADP is currently under revision, and the Swiss Parliament adopted the revised bill in the final vote on 25 September 2020. The revised FADP is expected to enter into force in the course of 2021 and will only apply to data pertaining to individuals (data pertaining to legal persons will no longer be protected). In EU/EEA cross-border relationships, the EU General Data Protection Regulation (GDPR) may also need to be considered, given its extraterritorial reach.

Non-compliance with any of the general data processing principles of lawfulness, good faith, proportionality, purpose limitation and transparency would require a legal justification (ie, the data subject's consent, overriding private or public interest or a Swiss statutory provision). In particular:

- personal data may only be processed for the purpose indicated at the time of collection, that is evident from the circumstances or that is provided for by Swiss law;
- the principle of transparency requires that the collection of personal data and the purpose of its processing must be evident to the data subject; and
- the principle of proportionality provides that personal data is disclosed only to the extent required for the specific purpose – ie, any personal data should be appropriately anonymised, pseudonymised or encrypted or, if the customer data needs to be processed in cleartext, then access should only be granted to the extent required (eg, by the implementation of an appropriate authorisation and access concept with regard to personal data).

Finally, FINMA Circular 2018/3, Outsourcing – banks and insurers of 21 September 2017 is applicable to the outsourcing of a function that is significant to the company's business activities and that will be mandated to a third party in order to independently and on an ongoing basis perform all or part of such function. Significant functions are those that have a material effect on compliance with the aims and regulations of financial market legislation. Outsourcing is not considered an unlawful disclosure under the Banking Act if the outsourcing provider and its employees are obliged to comply with bank secrecy rules.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Basel III Standards

Switzerland has, to a large extent, implemented the Basel III standards by means of amendments to its Capital Adequacy Ordinance, Liquidity Ordinance and various FINMA circulars.

### Capital Requirements

Subject to any exception granted by FINMA, the fully paid-in minimum share capital of a bank shall amount to at least CHF10 million, although FINMA may require a higher amount of share capital depending on the bank's intended business activities.

Non-systemic banks must hold a minimum regulatory capital of at least 8% of their risk-weighted positions, and must have a capital buffer of between 2.5% and 4.8%. Upon the request of the SNB, an additional countercyclical buffer to address excessive credit growth risks can be introduced. For example, a countercyclical buffer was introduced to address risks of overheating in the real estate sector, and was set prior to March 2020 at 2% of the risk-weighted positions whereby a residential property in Switzerland acts as real security. In March 2020, the Federal Council approved the deactivation of this countercyclical capital buffer in order to give banks more flexibility in granting credits as a way to limit the economic impact of the COVID-19 pandemic.

Banks with a balance sheet amount of at least CHF250 billion, of which the total foreign commitment amounts to at least CHF10 billion, or with a total foreign commitment of at least CHF25 billion, are further required to hold an extended countercyclical buffer of up to 2.5%. Furthermore, FINMA may require a bank to hold additional capital if the minimum regulatory capital and capital buffer do not ensure an appropriate level of security in view of the specific risks faced by the bank. Finally, a non-systemic bank must maintain a minimum leverage ratio of 3% based on Tier 1 capital and its unweighted exposures (total exposure).

There are additional requirements for SIBs, which must hold enough regulatory capital to continue their operations even if they incur large losses (going concern capital) and must provide additional loss-absorbing funds (gone concern capital). The going and gone concern requirements comprise together the bank's total loss-absorbing capacity (TLAC). The going concern capital requirements for SIBs consist of the following elements:

- a base requirement of a risk-weighted capital ratio of 12.86% and a leverage ratio of 4.5%;
- a surcharge that depends on the degree of systemic importance; and
- countercyclical buffers.

The gone concern capital requirements for domestic systemically important banks (D-SIBs) amount to a minimum of 40% of their going concern capital, subject to rebates. The gone concern capital requirements for the two global SIBs (G-SIBs) at the consolidated group level are 100% of their going concern capital minus certain rebates granted by FINMA.

Following a pilot phase, as of 1 January 2020 FINMA implemented a small bank regime exempting small, particularly liquid and well-capitalised banks from certain regulatory requirements. Such banks benefit from less complex requirements under the Capital Adequacy Ordinance that allows them, for instance, to forego the calculation of risk-weighted positions. Please see **2.1 Licences and Application Processes** for a description of the requirements that a bank must meet in order to be allowed to participate in the small bank regime.

#### Risk Diversification

Banks are obliged to limit concentration risks and must comply with various requirements in this respect. The standard upper limit for any large exposure is, in principle, 25% of the bank's adjusted eligible core capital (Tier 1), save for any exceptions or other specific requirements provided in the Capital Adequacy Ordinance and in FINMA Circular 2019/1 "Risk diversification – banks".

#### Liquidity Requirements

The Liquidity Ordinance implemented Basel III's liquidity standards into Swiss law, and regulates the qualitative and quantitative liquidity requirements applicable to banks. Further specifications are contained in FINMA Circular 2015/2 "Liquidity Risks – Banks".

Under the Liquidity Ordinance, banks are required to appropriately manage and monitor their liquidity risks.

A liquidity coverage ratio (LCR) has been introduced into the Liquidity Ordinance in accordance with international liquidity standards, and shall ensure that banks have an adequate portfolio of high-quality liquid assets (HQLA) to cover the expected net cash outflow for a 30 calendar day liquidity stress scenario on an ongoing basis. Banks have to report their LCR to the SNB on a monthly basis.

The net stable funding ratio (NSFR) has not yet been implemented in Switzerland due to delays in its international implementation, but in September 2020 the Federal Council adopted an amendment to the Liquidity Ordinance in order to introduce the NSFR. This amendment is due to enter into force on 1 July 2021.

SIBs are subject to more stringent liquidity requirements than non-systemic banks.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

#### Applicable Insolvency Rules

The Banking Act sets out the debt enforcement and insolvency proceedings in articles 25 et seq, as further specified in the BIO-FINMA. These provisions apply to banks licensed in Switzerland under the Banking Act (with either a Bank Licence or a FinTech Licence). They also apply to securities firms and fund management companies regulated under the FinIA and licensed by FINMA.

According to articles 25 et seq Banking Act, where FINMA has reasons to believe that a bank it regulates or supervises is either over-indebted or has incurred serious liquidity problems, or does not fulfil the capital requirements upon a respective rectification period granted by FINMA, it may, as appropriate:

- take protective measures under article 26 Banking Act;
- initiate bank reorganisation proceedings under articles 28-32 Banking Act; or
- order the liquidation of the bank (bankruptcy proceedings) under articles 33 et seq Banking Act.

### Protective Measures

Protective measures may be ordered by FINMA either on a stand-alone basis or in connection with bank reorganisation proceedings or the liquidation of a bank. Article 26 para. 1 Banking Act mentions the following protective measures:

- instructions to the corporate bodies of the bank;
- the appointment of an investigating officer;
- the withdrawal of the power of the corporate bodies to represent the bank or the removal of the corporate bodies from office;
- the removal of the bank auditors or corporate auditors from office;
- the restriction of the business activities of the bank;
- a prohibition on making or receiving payments or entering into securities transactions;
- the closure of the bank; and
- ordering a stay (*Stundung*) or postponement of maturity (*Fälligkeitsaufschub*), except for debts owed to central mortgage bond institutions (*Pfandbriefzentralen*), which are secured by a pledge.

The above list of measures is not exhaustive and FINMA may also take other measures, as it deems appropriate. From a Swiss perspective, any such protective measures ordered by FINMA may also be ordered in respect of the assets of the bank located outside Switzerland in a foreign branch.

### Reorganisation Proceedings

Reorganisation proceedings may be ordered by FINMA if there is a reasonable expectation that the failing bank may be successfully restructured or if at least some parts of it may be saved from insolvency. In such event, FINMA may appoint an administrator (*Sanierungsbeauftragter*) and regulate the business activities of the bank during such proceedings (article 28 Banking Act). Where reorganisation proceedings are commenced, a reorganisation plan will be prepared by the administrator, which must be approved by FINMA (such approval may occur when FINMA resolves to commence the reorganisation proceedings). There is no requirement for an approval by a general shareholders' meeting of the bank (article 31 Banking Act). Moreover, the creditors of a SIB may not reject the reorganisation plan (article 31a para. 3 Banking Act).

A reorganisation plan may provide for the transfer of the entire business of the financial institution or certain parts of the assets and liabilities as well as contracts to another legal entity (eg, a bridge bank), or for a bail-in of debt, or for a haircut on claims.

If the reorganisation plan provides for a bail-in of debt or a haircuts on claims, such measures must ensure that, after a reorganisation, the bank meets the capital requirements necessary for the purposes of continuing the business activities. In any such case, article 48 BIO-FINMA provides for a creditors' hierarchy (waterfall). Under such rules, before a bail-in of debt or haircuts on claims would apply, the share capital must be reduced exhaustively, any contingent convertibles or other capital instruments qualifying as Additional Tier 1 Capital or Tier 2 Capital must be converted into equity or written off, and any other claims ranking junior must be converted into equity or written off. In such waterfall, deposits (in respect of the amount not protected by any deposit insurance scheme) would rank last.

Any such bail-in of debt or haircut could not be applied in respect of privileged claims (eg, deposits up to CHF100,000 – see **6.1 Depositor Protection Regime**), secured claims up to the value of the collateral assets and, under certain conditions, claims subject to a right of set-off (article 49 BIO-FINMA).

### Insolvency Proceedings

FINMA may order bankruptcy proceedings under articles 33 et seq Banking Act, irrespective of whether it first ordered protective measures under article 26 Banking Act or bank reorganisation proceedings under articles 28-32 Banking Act.

Article 34 para. 1 Banking Act provides that bankruptcy proceedings ordered by FINMA have the same effect as the start of bankruptcy proceedings pursuant to articles 197-220 of the Swiss Debt Enforcement and Bankruptcy Act (DEBA) and, according to article 34 para. 2 Banking Act, the bankruptcy proceedings are administered according to the rules of articles 221-270 DEBA. However, this is subject to any rules departing from the DEBA in the Banking Act, and FINMA may deviate from the rules of the DEBA as it deems appropriate.

Swiss and foreign creditors are equally entitled to file their claims in the Swiss insolvency proceedings, including creditors of foreign branches (article 3 para. 2 BIO-FINMA).

From a Swiss perspective, the principle of universality applies in respect of insolvency proceedings commenced in respect of a bank under articles 33 et seq Banking Act. As a result, all assets owned by a bank at the time of the opening of insolvency proceedings against it form part of the bankruptcy estate, irrespective of their physical location, provided that such assets are not exempted from bankruptcy proceedings (as would be the case for assets subject to sovereign immunity).

Based on the general rules of the DEBA, in bankruptcy proceedings a bank may no longer dispose of the assets of the bankruptcy estate – such dispositions would be void towards the creditors (article 204 DEBA). For these purposes, the time specified by FINMA as the start of the bankruptcy proceedings is relevant. Moreover, claims forming part of the bankruptcy estate can no longer be validly discharged by payment to the debtor, but must be paid into the bankruptcy estate.

As regards liabilities, the opening of bankruptcy proceedings has the effect that all obligations of such bank become due against the bankruptcy estate, with the exception of those secured by mortgages on the bank's real estate (article 208 DEBA). Non-monetary claims will be converted into monetary claims of corresponding value (article 211 DEBA).

**Implementation of International Commitments**

With the Swiss rules on reorganisation proceedings, Switzerland implemented the Financial Stability Board (FSB) recommendations on effective resolution regimes. It also introduced a competence for FINMA to exercise resolution stay powers.

Under article 30a Banking Act, and in connection with protective measures under article 26 Banking Act or reorganisation proceedings under article 28-32 Banking Act, FINMA has the power to order a temporary stay of:

- any contractual termination right of a counterparty or the exercise of any rights of set-off;
- the enforcement of collateral; or
- the "porting" of derivatives transactions, in any case for up to two business days, if such contractual termination or other right would otherwise be triggered by such protective measures or reorganisation proceedings (article 30a para. 1 to 3 Banking Act).

According to article 12 para. 2bis Banking Ordinance, when entering into new agreements or amending existing agreements, a bank licensed by FINMA must agree with the counterparty the application of the resolution stay powers of FINMA according to article 30a Banking Act, provided that the agreement is subject to a law other than Swiss law or provides for the jurisdiction of courts other than Swiss courts, and provided that the agreement is included on a list of contracts in the scope of such obligation (article 56 para. 1 lit. a to h BIO-FINMA), including derivatives transactions, repo transactions, intrabank credit agreements and master agreements in relation thereto.

# 10. Horizon Scanning

## 10.1 Regulatory Developments

**Implementation of FinSA and FinIA**

While the FinSA and the FinIA have been in place since 1 January 2020, the implementation of the new rules is still subject to transition periods.

By 24 December 2020, financial services providers will have to adhere to a Swiss ombudsman service, unless they only offer services to professional or institutional clients in the sense of the FinSA. This obligation will apply to Swiss and foreign banks that are interacting with retail clients in Switzerland.

Foreign financial services providers not subject to FINMA supervision will have to make sure the client-facing front office staff members are registered with a Swiss registration body for client advisers by 19 January 2021. Foreign financial services providers subject to prudential supervision in their home jurisdiction (eg, investment firms in the sense of MiFID) that are transacting only with professional or institutional investors in Switzerland are exempted from this requirement under the FinSO.

As regards the new point of sale obligations introduced by the FinSA for financial services providers such as banks active in the brokerage, advisory or asset management business, the client-facing obligations will have to be fully implemented by the end of 2021. By such deadline, financial services providers will have to complete the segmentation of clients into the categories of retail, professional and institutional, and will have to comply with the following relevant obligations, as applicable to the client category:

- an obligation to provide the relevant information to the clients (including standardised information, product and services-related disclosures, pre-trade disclosure of key information documents, information on the market offers taken into account and on conflicts of interest);
- completing the suitability and appropriateness tests in compliance with the requirements of the FinSA;
- informing clients where no suitability or appropriateness test is undertaken;
- fulfilling documentation requirements and accountability to the client during the timelines set by the regulation; and
- best execution in compliance with the requirements of the FinSA.

**LIBOR Transition**

FINMA closely monitors international developments as regards the end of LIBOR, which is expected to occur around the end of 2021. FINMA has recommended that participants in the derivatives market enter into new transactions including the market-standard fallback clauses, and adhere to the terms of the LIBOR Fallbacks Protocol published by ISDA or, as applicable, enter into bilateral agreements with the same effect (eg, on the basis of the documentation published by the Swiss Banking Association), for those transactions forming part of a trading book of legacy transactions with a term beyond the end of LIBOR.

For the floating rate notes and the loan markets, the relevant documentation solutions in the respective markets will have to be taken into account.

To the extent that it will not be possible to include such fallback clauses in transactions, the question will arise of how to deal with such "tough legacy transactions". FINMA will require a risk assessment of such portfolios and the provision of a strategy regarding how to mitigate such risks.

### Introduction of DLT Rights

Swiss securities laws in their current form are a limiting factor as regards the issuance and trading of capital markets instruments in the form of digital assets issued on a distributed ledger (crypto-assets or tokens). Aiming to expand the potential use-cases of such distributed ledger technology (DLT) going forward and at the same time put the transactions on a robust legal basis, on 25 September 2020 the Swiss Parliament adopted an act to improve the current legal framework for DLT (the DLT Act), which will presumably enter into force on 1 August 2021 together with the implementing secondary legislation by way of amendment of the relevant ordinances, currently under consultation until 2 February 2021.

Without regulating or endorsing any particular technology, the DLT Act amends various existing laws in order to remove legal obstacles that hampered the development of a functioning market for Tokens that are a digital representation of financial instruments. The most important innovations of the DLT Act are the introduction of:

- "DLT rights" as a new type of right designed for digital assets;
- a right to set-aside crypto-assets held by a custodian for clients; and
- a new licence category for trading venues for DLT Rights and foreign securities that are transferred on a distributed ledger.

DLT Rights may become the digital equivalent of certificated securities or uncertificated securities by linking a right to a registration on a distributed ledger instead of a certificated security instrument or a registration in an uncertificated securities register. DLT Rights may not be exercised or transferred outside of the relevant distributed ledger. Any rights that could be issued as certificated or uncertificated securities may be issued as DLT Rights.

Under the draft ordinances relating to the DLT Act, holding payment tokens via omnibus client accounts would bring the service provider of such custody solution into the scope of a requirement to obtain a FinTech Licence as a bank.

### Revision of Bank Insolvency Rules

On 19 June 2020, the Swiss Federal Council proposed a bill for the reform of the reorganisation and insolvency rules (the Bank Reorganisation Reform Bill 2020), which is scheduled to be discussed in the Swiss Parliament in 2021. Among other proposals, it will:

- incorporate the rules regarding the waterfall of how rights, equity and debt instruments are bailed-in into the Banking Act (such rules are currently part of the BIO-FINMA);
- introduce the power to carve-out certain financial instruments issued by cantonal banks with a guarantee by the sovereign from the bail-in waterfall;
- introduce a reform of the rules on the pay-out of proceeds in the depositor protection scheme; and
- introduce an obligation of securities custodians to segregate own positions from client positions.

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**Schellenberg Wittmer** has a Banking and Finance Group in Zurich and Geneva comprised of more than 20 Swiss lawyers with in-depth understanding of the regulatory environment of all types of financial institutions and the domestic and international financial markets. Many of the practice lawyers have gained in-house experience while working for banks, asset managers, regulators and international law firms. The firm's experience and expertise, together with the size of the team, enables it to provide top-quality and tailor-made advice concerning finance transactions and regulatory issues of every type. The team acts regularly on behalf of Swiss and foreign banks and other financial institutions, such as investment firms, insurance companies, fund management companies and asset managers, across a broad range of regulatory matters, including the establishment and licensing of financial institutions in Switzerland, the regulation of financial services and other activities subject to prudential supervision or regulation, the structuring of capital transactions for banks, M&A of financial institutions, and audit mandates granted by FINMA for investigations in financial institutions.

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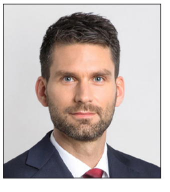

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Schellenberg Wittmer

# Trends and Developments

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## Reverse Solicitation in Switzerland

Reverse solicitation designates the circumstances in which a financial intermediary provides certain services to a client upon the latter's request, without prior solicitation by the financial intermediary. Where the financial intermediary can rely on reverse solicitation, it generally avoids licensing requirements and regulatory duties.

The concept is not specific to Swiss law. For instance, EU law defines reverse solicitation in article 42 of MiFID II (EU Directive3 2014/65 of 15 May 2014) as a situation where a client "initiates at its own exclusive initiative" the provision of an investment service or activity by a financial intermediary. According to the European Securities and Markets Authority (ESMA), reliance on reverse solicitation implies that the financial service provider does not – either itself or through a related entity or an agent acting on its behalf – promote or advertise its services or activities, regardless of the communication means, including press releases, advertising on the internet, brochures, phone calls or face-to-face meetings.

Reverse solicitation also exists under Swiss law. It has assumed increased importance this year, with the coming into force of a new set of laws and regulations that aim to create a level playing field at the point of sale for all financial service providers, and to upgrade Swiss financial legislation so that it comes closer to the MiFID II standards.

This article provides a brief outline of this recent development in the Swiss financial services legislation. The evolution of the Swiss approach towards reverse solicitation is also described, from the previous legal framework to the new set of rules, ending with some considerations on the current transitional period.

### *Outline of the new legislation*

Historically, the regulatory framework in Switzerland focused on the supervision of institutions (banks, securities firms, fund management companies and, more recently, financial market infrastructures) and the regulation of certain financial products – ie, collective investment schemes and structured products. The principles governing the provision of financial services were primarily derived from the provisions of Swiss contract law on mandate agreements. For instance, the restrictions on the payment of retrocessions to financial institutions arose from the general accountability duty of agents towards their clients. Certain succinct conduct of business rules were set out in the law governing the activities of securities firms – and banks when they act in such capacity – completed by self-regulations. Independent investment managers, who constitute a large portion of the Swiss financial centre, were not subject to such conduct of business rules.

After a relatively long period of preparatory work and discussions between representatives of the industry, scholars and regulators, new laws were adopted by the Swiss Parliament on 15 June 2018, which do the following:

- extend the scope of licensing requirements to the investment management industry;
- subject pure financial advisers (who have no discretionary authority over their clients' assets) to registration duties; and
- introduce a series of minimum requirements applicable to all financial service providers, including foreign institutions when they serve Swiss clients.

Alongside corresponding organisational requirements and information/reporting duties, these new conduct of business rules are set out in the Swiss Financial Services Act (FinSA), which came into force on 1 January 2020, together with implementing regulations.

As the new rules represent a major change in the approach of Swiss financial legislation towards the provision of financial services, a transitional period of two years has been granted for the regulated entities to adapt their procedures and satisfy the new requirements. That transitional period will end on 31 December 2021. From 1 January 2022, all financial service providers will have to comply with the new rules. Those institutions that have already taken the necessary steps may elect to apply the new rules by way of anticipation at any time during the transitional period, with such election being definitive (no way back).

Obviously, due to this major shift in the Swiss financial rules, the scope and definition of the reverse solicitation exemption have also evolved.

### *Reverse solicitation before the FinSA*

Before the FinSA came into force, foreign financial service providers offering services in Switzerland were not caught by the Swiss supervisory framework, except under the somewhat limited scope of the Swiss Collective Investment Schemes Act of 23 June 2006 (CISA). The offering of open-ended and close-ended collective investment vehicles was subject to the approval of the Swiss Financial Market Supervisory Authority (FINMA) if the circle of targeted investors included retail investors. There was a private placement exemption for foreign fund managers who chose to offer their products to qualified investors only – ie, such offer did not need FINMA approval. An offering to unregulated qualified investors, such as retirement benefit institutions (pension funds) with professional treasury management, or to high net worth individuals was, nevertheless, subject to the prior appointment of a representative and paying agent in Switzerland. That specific appointment requirement was introduced by way of a 2013 amendment to the CISA. It is at that time that the reverse solicitation exemption became more relevant, because the appointment requirement would fall away if the offer was made by way of reverse enquiry.

While the Swiss financial legal framework was – and still is – rather liberal compared to the applicable regulations in the European Union or the United States, the reverse solicitation exemption was described restrictively. Article 3(2)(a) CISA practically assimilated the reverse solicitation to execution only. Its implementing regulation (article 3(2)(b) of the Collective Investment Scheme Ordinance) stated that the possibility to rely on the reverse solicitation exemption was limited to circumstances where the respective fund manager or placement agent had not had (any) preliminary contacts with the investor. Practically speaking, the exemption would no longer be available after meeting with potential investors, even in a pre-marketing context, to present the activities and track record of the fund manager, for instance. This narrow definition generated criticism amongst scholars and professionals. Conversely, the distribution concept that triggered the need to appoint a representative and paying agent in Switzerland was so broadly defined that it further narrowed down the scope of the reverse solicitation exemption. Legal advisers would generally alert their clients to the restrictive scope of the exemption, insisting on the fact that reverse solicitation should be relied upon only exceptionally, and should definitely not be considered as a business model.

The offering of structured products was also regulated under the CISA and subject to similar limitations. However, the distribution to qualified investors was subject to a full private placement exemption, so that reverse solicitation has played a limited role in that context.

### *The FinSA regime*

Under the FinSA, financial service providers are subject to enhanced conduct of business rules, the scope of which depends on the type of client concerned, and are accordingly required to classify their clients as either institutional, professional or retail clients. Professional clients include regulated financial intermediaries and insurance companies, central banks, large enterprises, public and private institutions (including pension funds) with professional treasury management, and professionally managed private investment structures. Retail clients comprise all investors that are not – or have elected not to be – considered as professional clients. A third category, called institutional clients, regroups a sub-category of professional clients (ie, the regulated institutions and the central banks) and national and supra-national institutions governed by public law, provided that they have professional treasury management. Qualifying high net worth individuals may opt out from the retail investor protection regime and elect to be considered as professional clients (elective professional clients).

A financial service provider may elect to treat all of its clients as retail clients and thus avoid the requirement to classify them into categories. It may also prefer to restrict the scope of its clients to professional and institutional clients. For the latter, the coming into force of the FinSA will have a limited impact, because conduct of business rules are not applicable if the investor is an institutional client or can be partially waived by the client if the latter is a professional, but not institutional, client. Conduct of business rules include the duty to verify the appropriateness of isolated investment advice and the suitability of investments recommended by a portfolio adviser or made under a discretionary management contract, but such duty does not apply when the investor is a professional client, unless there is doubt as to the level of skills and experience of such investor.

The CISA and the private placement exemption set out therein have been updated simultaneously with the adoption of the FinSA to take the new FinSA approach into account. The distribution concept, which was the key concept in the former version of the CISA, will lose all relevance at the end of the transitional period of two years. From 2022, the promoters of collective investment schemes will have to take into consideration both the FinSA rules, which may apply in connection with the placement of collective investment schemes (particularly foreign unregistered funds), and the revised CISA private placement exemption. Following strong lobbying from the Swiss investment fund industry, the definition of financial services under the FinSA has been extended to cover those activities relating to the acquisition of financial instruments (which includes the promotion of collective investment schemes). This explains why pure fund promoters will generally be treated as financial service providers under the FinSA, even if they target only institutional or professional clients. The private placement exemption has been slightly enlarged, in the sense that professional clients, other than elective professional clients, can be targeted without the need to appoint in Switzerland a representative and paying agent for the fund. The requirement to appoint such a representative will continue to apply when any type of publicity in respect of a foreign fund is addressed to elective professional clients.

Under this revised legal framework, the reverse solicitation exemption has accrued greater importance, as it enables foreign financial service providers not only to propose unregistered investment funds, but also to render services to retail investors, without being subject to FinSA requirements. Reliance on reverse solicitation will also permit the avoidance of the obligation for foreign funds to appoint a representative and paying agent when the scope of potential investors includes elective professional clients. The exemption is now defined in the Financial Services Ordinance, which is an implementing regulation of FinSA. Given that the distribution of collective investment schemes is generally deemed a financial service, the exemption applies under both the CISA and the FinSA.

The exemption applies to all financial services that are provided at the express initiative of the client, whether the financial service is granted on an isolated basis or in the framework of a pre-existing clientele relationship. In the latter case, this implies that the client relationship itself has been established at the express initiative of the client. The former condition of absence of prior contact with the potential client is not expressly set out in the regulation but continues to be relevant: the commentaries made by the Swiss Federal Finance Department on the Financial Services Ordinance expressly refer to the MiFID II reverse solicitation exemption. The Swiss approach therefore reflects the approach adopted in the European Union. These commentaries have also clarified that a response to a request for proposal made by a Swiss investor falls within the scope of the reverse solicitation exemption, as does an increase of an investment previously made by a client at their own initiative.

### *Transitional period*

As mentioned, the former legal framework may apply until the end of 2021 to those financial service providers who do not elect to submit to the new regime by way of anticipation. Foreign fund promoters are, however, rather inclined to make such an election, if they target only professional clients, as it enables them to avoid the requirement to appoint a representative or a paying agent for their funds in Switzerland.

From a reverse solicitation perspective, the transitional period is in principle of little relevance. It may, as mentioned, apply to the provision of (unsolicited) new financial services under a pre-existing client relationship, provided that the relationship was established at the client's express initiative – in other words, if a client relationship is commenced at the client's initiative, then all financial services provided to the client under that relationship are covered by the exemption. This is a new aspect. The transitional period is, however, not a grand-fathering period – ie, client relationships initiated prior to 1 January 2020 are (or will be, from 1 January 2022) subject to the FinSA requirements unless the financial service provider can prove that they had been established at the client's initiative. In case of investigation, the financial service provider must be able to produce related evidence. For client relationships dating back to the period where Switzerland had a large cross-border exemption for financial services, there was no need to collect such evidence; it may be extremely difficult to retrieve it now.

### *Conclusion*

The Swiss financial services legislation has been heavily amended and the scope of the reverse solicitation exemption has not been extended. While it may play an increased role considering the broader scope of the legislation, the exemption remains narrowly defined. Experience will show if it is relied upon widely by financial intermediaries.

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# TAIWAN

## Law and Practice


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## Contents

# 1. Legislative Framework

## 1.1 Key Laws and Regulations

### Principal Laws and Regulations

The principal laws and regulations governing the Taiwan banking sector include the Banking Act, the Financial Holding Company Act, the Central Bank of the Republic of China (Taiwan) Act, the Regulations Governing Foreign Exchange Business of Banking Enterprises and the foreign exchange control-related laws and regulations, the Consumer Protection Act and the Financial Consumer Protection Act, and other related laws and regulations. Moreover, for banks concurrently conducting other businesses such as acting as a trust enterprise, electronic payment institutions, etc, the relevant laws and regulations governing such businesses also apply.

### The Banking Act and the Financial Holding Company Act

The Banking Act is the primary law governing the Taiwan banking industry and provides rules for conducting banking business, including the setting up and dissolution of banks, the scope of banking business, compliance requirements for banks' business, finance, internal control and other matters, administration and supervision by the regulator, etc. In addition, for banks that are subsidiaries of financial holding companies, another of the major governing laws for the banking sector is the Financial Holding Company Act, which governs the establishment, business, finance, administration and supervision of financial holding companies.

### The Central Bank of the Republic of China (Taiwan) Act, the Regulations Governing Foreign Exchange Business of Banking Enterprises and the Foreign Exchange Control-Related Laws and Regulations

Foreign exchange-related activity is governed by the Central Bank of the Republic of China (Taiwan) Act, the Regulations Governing Foreign Exchange Business of Banking Enterprises and the foreign exchange control-related laws and regulations, and is regulated by the Central Bank of the Republic of China (Taiwan) (CBC). Such laws and regulations also govern banks' business operations involving foreign exchange. For example, the Regulations Governing Foreign Exchange Business of Banking Enterprises provide the scope of foreign exchange business, requirements for managing foreign exchange business, and administration and supervision by the regulator, etc.

### The Consumer Protection Act and the Financial Consumer Protection Act

The Consumer Protection Act provides the general rules and requirements for the protection of the interests of all consumers, and the Financial Consumer Protection Act focuses on the protection of consumers who deal with banks and other financial institutions. The Financial Consumer Protection Act provides, among others, requirements on the advertising of financial products and services, contracts with consumers, and the procedures for financial consumer dispute resolution in order to reasonably and effectively handle financial consumer disputes.

### Regulators – FSC and CBC

The Financial Supervisory Commission (FSC) and the CBC are the major regulatory authorities regulating banks in Taiwan.

The FSC is the primary competent authority regulating the financial markets and financial institutions in Taiwan. It determines financial policy, issues regulations and rules, conducts financial examinations and supervises financial institutions. The FSC has four bureaus: the Banking Bureau, the Securities and Futures Bureau, the Insurance Bureau and the Financial Examination Bureau. While the FSC regulates financial markets and financial institutions generally, the Banking Bureau focuses on the banking sector, and the Financial Examination Bureau is in charge of financial examination of all financial institutions regulated by the FSC.

The CBC, Taiwan's central bank, sets monetary policy to regulate the availability of money and credit. It also regulates foreign exchange activities and business, and conducts examinations on banks.

# 2. Authorisation

## 2.1 Licences and Application Process

### Types of Licences

According to the Banking Act, banks in Taiwan are categorised into three different types based on the main operations and purposes of the bank:

- commercial banks;
- banks for a special business purpose; and
- investment and trust companies.

Commercial banks are the major and most common type of bank in Taiwan, and their principal function is to accept deposits and extend loans. Banks for a special business purpose are established primarily to facilitate the extension of specialised credit, such as agricultural credits, export-import credits, credits for medium and small-sized enterprises and real estate credits. However, as such functions may also be performed by commercial banks, the establishment of banks for a special business purpose has been gradually declining, and most such banks have transformed into commercial banks. Investment and trust companies act as trustee to accept, operate, manage and employ trust funds and manage trust properties, or act as an investment broker to invest in funds and capital markets for specific purposes. There is currently no investment and trust company as all such companies have transformed or merged into commercial banks. Therefore, the following discussion will focus on commercial banks.

In addition, in order to support and promote international financial activities, banks may apply to the FSC and CBC for a licence to establish Offshore Banking units, which can engage in foreign currency-denominated financing business in Taiwan without being subject to foreign exchange-related regulations.

Also, apart from traditional banks with physical branches, the FSC has recently agreed to the establishment of three online-only banks, and it is anticipated that such online-only banks may start to offer deposit, debit card and small loan services by the end of this year.

#### Scope of Services and Restrictions on Licensed Banks' Activities

According to Article 71 of the Banking Act, the main business activities of a commercial bank include accepting deposits, issuing bank debentures, investing in securities, handling domestic and foreign remittances, offering loans and credit, providing guarantees, and acting as the agency bank in related banking business.

Besides the normal scope of services set forth in the Banking Act, a bank may also concurrently conduct other business upon the approval of the FSC. For instance, a bank may concurrently operate trust enterprise business, insurance agent or insurance broker business, financial advisory services, electronic payment business, etc.

#### Statutory and Other Conditions for Authorisation

The statutory restrictions on and implications of authorisation could be found in three major aspects: the paid-in capital, responsible persons of the bank, and the ownership.

The minimum paid-in capital requirement for establishing a commercial bank is NTD10 billion (approximately USD350 million), and the contribution must be made in cash only.

According to the Regulations Governing Qualification Requirements and Concurrent Serving Restrictions and Matters for Compliance by the Responsible Persons of Banks, the general restrictions and requirements for the responsible persons of a bank include that the person must not have been sentenced to imprisonment for certain financial crimes or in violation of financial regulations, must not concurrently hold positions that may be in conflict of interest, must have adequate knowledge, capability and experience in banking business, etc.

A person must obtain the FSC's approval before it acquires more than 10%, 25% or 50% of the issued voting shares of a bank. There is no restriction on foreign ownership and the FSC is generally receptive to foreign investors. However, PRC investors are subject to the PRC ownership restriction and a different approval process.

#### Process for Applying for Authorisation, Including Timelines, Costs and Engagement with the Regulators

According to the Standards Governing the Establishment of Commercial Banks, the following are the major steps and regulatory approvals generally required for the establishment of a bank.

Firstly, the founders of the bank shall subscribe up to 80% of the total paid-in capital of the bank at the time of initiation. Secondly, the founders are required to submit an application for the FSC's approval; the application documents shall include a business plan, founder's qualification declaration, source of funds, articles of association, the paid-in capital and equity instruments of the bank, etc. After the establishment is approved by the FSC and within three months after completing the incorporation registration with the Ministry of Economic Affairs, the bank shall apply to the FSC for its business licence. The licence fee is one-four thousandth of the total capital specified in the articles of association of the bank.

During the establishment process of the bank, the FSC or other competent authorities may designate its personnel to examine the matters relevant to the bank establishment, and may order the applicant to provide certain supporting documents or make explanations at any time. Also, if the bank's shareholders, directors, supervisors or managers do not meet the requirement, if the bank fails to complete preparation before start of business, or if any condition the FSC deems might lead to unsound and inefficient business operations of the bank occurs, the FSC may decide not to issue the business licence to the bank.

## 3. Control

### 3.1 Requirements for Acquiring or Increasing Control over a Bank

#### Requirements Governing Change in Control, Shareholding Thresholds and Other Restrictions

An investor of a bank would be subject to reporting requirements and/or the FSC's prior approval if its stake reaches a certain level.

If an investor and his/her spouse and children under 20 years of age (if any) in aggregate hold 1% or more of the voting shares in a bank, such investor shall notify the bank of this.

A report to the FSC will be required if an investor (together with its/his/her related parties provided under the Banking Act) acquires or holds more than 5% of the voting shares of a bank. Any subsequent change in the shareholding by more than 1% is also required to be reported to the FSC.

A person (together with its/his/her related parties) must obtain the FSC's approval before its/his/her acquisition of 10%, 25% or 50% of the issued voting shares of a bank.

In addition, the shares held by a third party for or on behalf of the investor or its/his/her related parties in trust, by mandate or through other types of contract, agreement or authorisation should be aggregated with the shareholdings held by such investor or the related parties.

### Regulatory Filings and Related Obligations

The application documents sent to the FSC for the acquisition of 10% or more of the issued voting shares of a bank should include documents and information regarding the investor's existing shareholding, the proposed acquisition, the source of funds, and other documents and information that may be required by the FSC on a case-by-case basis.

Additional documents and information would be required in an application for the acquisition of 25% or 50% of the issued voting shares of a bank, including documents and information regarding the following:

- in an application for a 25% acquisition:
  - (a) the investor's business and finance conditions by which the investor may improve the soundness of the operation of the bank and its management strategy;
  - (b) the investment structure;
  - (c) an evaluation of the effect on the bank's business and finance condition within three fiscal years after the acquisition; and
  - (d) the CPA-audited financial statements of the investor (including its/his/her related parties) or alternative financial information for the last three fiscal years; and
- in an application for a 50% acquisition, in addition to the aforementioned application documents required for a 25% acquisition:
  - (a) a business plan;
  - (b) the proposed management team; and
  - (c) protection of the bank's employees' interests.

# 4. Supervision

## 4.1 Corporate Governance Requirements

### Relevant Statutory and Regulatory Requirements

In addition to the board of directors, a bank must set up an audit committee comprised of its independent directors to review important matters and transactions (including related parties transactions). Also, according to the Banking Act and the Implementation Rules of Internal Audit and Internal Control System of Financial Holding Companies and Banking Industries, a bank shall establish an internal audit system and internal control system comprising three main elements: a self-inspection system, a legal compliance system and a risk management mechanism to ensure effective corporate governance.

The internal control system of a bank should be approved by its board of directors. The internal control system shall cover all banking business activities and incorporate five major components. The first element and the basis for the implementation of an internal control system is the "control environment", which encompasses the integrity and ethical values of the bank, the supervision responsibilities of the directors and supervisors, the organisational structure, the assignment of authority and responsibility, human resources policies, performance measurements, awards and disciplines, and the code of conduct for all directors and employees. Second, the internal control system shall adopt a "risk assessment" procedure. The risk assessment results can assist the bank in designing, correcting and implementing the necessary controls in a timely manner. Third, the internal control system shall include various "control operations", namely to implement proper policies and procedures at all levels, business processes, and subsidiaries of the bank based on the risk assessment results to control risks. Fourth, the internal control system shall ensure an effective internal and external "information sharing and communication" mechanism. Last but not least, the bank shall constantly "monitor" all operations. Any findings of deficiencies by the internal control system shall be reported to the appropriate management levels.

To implement the internal control system, a bank shall establish an internal audit unit and have sufficient and competent personnel as full-time internal auditors performing internal control duties independently and impartially. The internal audit unit is directly under the board of directors and is required to report its audit matters to the board of directors and audit committee at a minimum period of every six months. In addition, a bank should appoint a chief auditor to manage all audit matters. The chief auditor is not allowed to take a job that will cause conflicts or limitations to the audit work. The employment, dismissal or transfer of the chief auditor should be approved by the consent of the majority of audit committee members as well as the consent of more than two-thirds of the board of directors, and should be reported to the FSC for ratification.

According to the Banking Act, a bank that fails to establish or diligently implement the internal control and audit systems should be subject to an administration fine of between NTD2 million and NTD50 million.

### Voluntary Codes and Industry Initiatives

The Bankers Association of Taiwan (BA) may issue various discipline rules based on the authorisation of the applicable laws and regulations. Those discipline rules issued by the BA should be submitted to the FSC for ratification. A bank that fails to meet the requirements under the discipline rules would be deemed by the FSC as failing to establish or diligently implement the internal control and audit systems, and should be subject to the administration fine as mentioned above.

## 4.2 Registration and Oversight of Senior Management

### Directors' and Senior Managers' Designation and the Regulatory Approval of Appointments

The Banking Act and the Regulations Governing Qualification Requirements and Concurrent Serving Restrictions govern the designation of the responsible persons of a bank (including board members and senior managers). Generally, the responsible persons of a bank shall have good moral character and full competence serving in their positions, and must not have been sentenced to imprisonment for certain crimes.

### Chairperson of Board of Directors and Directors

Directors of the bank are elected by shareholders. Although it is not required to obtain prior approval from the FSC to be nominated or elected as the director of the bank, the FSC has stipulated relevant requirements to ensure the chairperson of the board and the directors are capable of managing and operating a bank. One of the FSC's main focuses on the supervision of chairpersons and the directors is the restriction on holding concurrent positions. The chairperson may not concurrently act as the general manager of the same bank, nor act as the chairperson of another financial institution (eg, bank, financial holding company, insurance company, securities firm, etc), nor act as the chairperson, general manager or equivalent role of a non-financial institution unless otherwise approved by the FSC. If the chairperson is allowed to hold concurrent positions in other companies, he/she must ensure that all positions are managed effectively and may not be in conflict of interest.

In addition, except for the banks that are 100% owned by the government or a single corporate shareholder, at least two of the directors of the bank shall meet any of the following qualifications:

- having at least five years' banking experience and having served as a vice manager or higher or equivalent position of the bank's head office;
- having three years' banking experience and having served as a manager or higher or equivalent position of the bank's head office; or
- having five years' of experience working in financial administration or management and having held the position of civil service recommended appointment grade 8 or higher or equivalent, with a good performance record.

The minimum number of directors required to meet said qualifications would increase according to the total number of directors and the total assets held by the bank.

### Senior Managers

The general manager of the bank shall meet any of the following qualifications:

- having a bachelor degree or an equivalent degree with at least nine years' banking experience, and having served at least three years in a management position; or
- having at least five years' banking experience and having served as a vice general manager or higher or equivalent position for at least three years, with a good performance record.

The relevant qualification documents shall be submitted to the FSC for approval before the appointment of the general manager of a bank.

Other senior managers, such as a vice general manager, assistant vice general manager and manager, are subject to other applicable qualification requirements regarding experience and expertise.

### Directors' and Senior Managers' Roles and any Accountability Requirements

The board of directors shall be responsible for the bank's overall business strategies and major policies, supervising the senior managers, and shall be accountable to all shareholders. The board of directors is also responsible for the implementation and supervision of the bank's internal control system.

Senior managers are appointed by and under the supervision of the board of directors. The general manager is responsible for handling the general operation of a bank. Other senior managers are delegated certain authority to assist the general manager in managing and operating the bank.

### 4.3 Remuneration Requirements

#### Individuals Subject to the Remuneration Requirements

According to the Corporate Governance Best-Practice Principles for Banks issued by the BA and ratified by the FSC, banks in Taiwan are advised to establish a remuneration committee led by and consisting of independent directors. In practice, all banks in Taiwan have independent directors serving on the board of directors, and most banks have set up a remuneration committee. The primary responsibility of the remuneration committee is to establish performance appraisal standards and remuneration standards for managers as well as sales persons, and the remuneration structure and system for directors.

#### Relevant Remuneration Principles

The remuneration standard and payment shall be based on performance, adjusted considering future risks and the long-term profitability challenges facing the banking industry and shareholders' interests to avoid inappropriate loss to the bank. Moreover, remuneration rewards should have a significant proportion paid in deferred or equity-related payment. Also, when assessing the contribution of individual directors, managers and employees, an overall assessment of the banking industry should be carried out to clarify that such profits are not due to advantages such as the lower capital cost of the banking industry. In addition, the remuneration system should not incentivise directors, managers and employees to engage in acts that exceed the risk appetite of the banking industry in order to pursue remuneration. Last but not least, the remuneration system and performance should be reviewed regularly.

#### Regulators' Supervisory Approach

A bank is required to disclose the remuneration of directors, supervisors, general managers, vice general managers, and chairpersons of the board and general managers rehired as consultants by disclosing the aggregate remuneration information, with the name(s) indicated for each remuneration bracket, or to disclose the name of each individual and the corresponding remuneration amount (as applicable) in its annual report.

#### Consequences of Breaching the Requirements

A bank that fails to comply with the disclosure requirement for the annual report should be subject to an administration fine of between NTD500,000 and NTD10 million.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

#### Principal Laws and Regulations

In Taiwan, the primary regulators for AML and CTF are the Investigation Bureau under Ministry of Justice (IBMOJ) and the FSC. The FSC has promulgated specific regulations governing AML and CFT in the banking sector, including the Regulations Governing Anti-Money Laundering of Financial Institutions, and the Regulations Governing Internal Audit and Internal Control System of Anti-Money Laundering and Countering Terrorism Financing of Banking Business and Other Financial Institutions.

#### KYC Requirements

First, a bank shall conduct due diligence on both new and existing customers taking a risk-based approach. The bank shall properly identify and verify the identity of the customer as well as the beneficial owner of the customer, and shall keep records on all relevant information. In particular, when the customer is a juristic person, the bank shall understand the business nature, equity structure and controlling person of the customer. Under a higher risk circumstance, the bank shall conduct enhanced customer due diligence. For ongoing customer due diligence, the bank shall regularly update all information at least once a year to ensure the business relationship with the customer is consistent with the bank's risk profile. The bank shall also understand the source of funds of the customer when necessary.

In addition, the bank shall verify the identity of the customer and keep relevant records of large cash transactions and report such transactions to the IBMOJ, with certain exceptions for government department and fund arrangements between financial institutions.

#### Suspicious Activity and Transaction Reporting

Last, the bank shall report to the IBMOJ all suspicious transactions, including attempted transactions. When reporting to the IBMOJ, the bank shall use the Suspicious Activity Report (SAR) form prescribed by the IBMOJ, covering, among others, the following information:

- the transaction details (eg, the type, currency and amount of the transaction);
- a statement of the reason for suspicion, including who, what, when and where; and
- the warning signs of money laundering activities.

If a transaction triggers the red flags (see below), it shall be reviewed under the risk-based assessment to decide whether it is a SAR transaction. If the financial institution holds the view that such red-flagged transaction has nothing to do with any AML and CTF activity based on the relevant facts and its assessment, the financial institution is not required to report the transaction to the IBMOJ. However, it must retain records of the determination and assessment on such transaction.

The BA implemented the red flags list for suspicious money laundering and terrorism financing transactions. However, such items are not exhaustive in their coverage. A bank should select or create suitable red flags based on its assets scale, geographic areas, business profile, customer-base profile, characteristics of transactions, and its internal money laundering/terrorism financing risk assessment or information on daily transactions, to identify red flag transactions of potential money laundering/terrorism financing.

# 6. Depositor Protection

## 6.1 Depositor Protection Regime

### Administrator of the Depositor Protection Scheme

The Deposit Insurance Act mainly governs the depositor protection regime in Taiwan. The Central Deposit Insurance Corporation (CDIC) was established on 27 September 1985, and is responsible for the management of the deposit insurance system.

### Classes of Deposits Covered by the Depositor Protection Scheme

Currently, the following deposits are covered by deposit insurance:

- checking accounts;
- demand deposits;
- time deposits;
- deposits required by law to be deposited in certain financial institutions; and
- any other deposits approved by the FSC.

### Limits Apply to the Amount of the Depositor Protection Scheme

If an insured institution is ordered to cease its business operations or is unable to pay off its deposits, CDIC compensates each depositor up to NTD3 million, including principal and interest.

### Funding of the Depositor Protection Scheme

The share capital of CDIC shall be subscribed by the Ministry of Finance, CBC and the insured financial institutions. The total capital subscribed by the Ministry of Finance and CBC shall exceed 50%. Financial institutions duly authorised to take deposits must take part in deposit insurance provided by CDIC and pay premiums for deposit insurance.

# 7. Bank Secrecy

## 7.1 Bank Secrecy Requirements

### The Banking Act

The Banking Act requires banks in Taiwan to keep the information regarding their customers and the relevant transactions (eg, deposit, loan or remittance) in strict confidence, unless the disclosure is otherwise permitted by applicable laws or the FSC, or unless the customers default on the repayment of debt. Violators will be subject to an administrative fine ranging from NTD2 million to NTD50 million.

### The Personal Data Protection Act

When collecting, processing and using personal data, Taiwanese banks also need to follow the requirements under the Personal Data Protection Act (PDPA). "Personal data" means any information that is sufficient to directly or indirectly identify an individual, such as name, date of birth, ID Card number, passport number, financial conditions, and data concerning a person's social activities.

The collection, processing (including storage), use and cross-border transmission of personal data by banks are subject to the PDPA, which includes obligations relating to consent securing, limitations on use, and notification requirements, etc. Disclosure is permitted if personal data has become public due to disclosure by the data subject or in a legitimate manner.

Banks must comply with the PDPA and establish security measures to protect personal data and dispose of it once the business relationship or need for the information ends. Failure to comply with the PDPA will result in a fine ranging from NTD50,000 to NTD500,000.

# 8. Prudential Regime

## 8.1 Capital, Liquidity and Related Risk Control Requirements

### Adherence to Basel III Standards

The principal rule regarding the capital adequacy of a bank is the Regulations Governing the Capital Adequacy and Capital Category of Banks, which adopted a number of elements of the Basel III framework.

### Risk Management Rules

A bank is required to self-assess its capital adequacy and establish its strategy to maintain its capital adequacy. Based on a bank's self-assessment, the FSC may request a bank to improve its risk management. If the bank fails to comply with such request, the FSC may order the bank to adjust its regulatory capital and risk-weighted assets, or to submit a capital restructuring plan within a certain period.

### Capital Requirements

The minimum paid-in capital for establishing a commercial bank in Taiwan is NTD10 billion. The promoters of the bank shall subscribe up to 80% of the total paid-in capital of the bank and the remaining shares shall be publicly offered; the capital contribution shall be made in cash.

Subject to certain exceptions, a branch of a foreign bank in Taiwan must allocate the minimum operating capital of NTD250 million if the Taiwan branch plans to conduct retail deposit business.

#### Capital Adequacy Requirement

The current capital adequacy requirements are generally in line with the standards under the Basel III framework, including:

- Common Equity Tier 1 Ratio (ie, net Common Equity Tier 1 divided by total risk-weighted assets): 7%;
- Tier 1 Capital Ratio (ie, net Tier 1 Capital divided by total risk-weighted assets): 8.5%; and
- Total Capital Adequacy Ratio (ie, aggregate amount of net Tier 1 Capital and net Tier 2 Capital divided by total risk-weighted assets): 10.5%.

#### Countercyclical Capital Buffer

To enhance the risk-bearing capacity and international competitiveness of domestic banks, the FSC has authorised the implementation of countercyclical capital buffers. The FSC will consult with the CBC and other relevant authorities, when necessary, to impose on banks an additional provision of a countercyclical capital buffer of up to 2.5%.

#### Liquidity Requirements

To enhance banks' short-term liquidity recovery ability, the FSC implemented the liquidity coverage ratio (LCR) framework in 2015. The LCR is calculated by dividing a bank's high-quality liquid assets by its total net cash flows over a 30-day period. Since 1 January 2019, banks incorporated under the laws of Taiwan must maintain an LCR of at least 100%.

The LCR requirement is not applicable to a branch office of a foreign bank in Taiwan. However, a foreign bank applying to establish a branch office in Taiwan must specify the liquidity risk management framework adopted by the head office and the liquidity risk management measures applicable to the Taiwan branch.

#### Additional Requirements Applicable to Systemically Important Banks

In 2019, the FSC announced the supervisory measures for systemically important banks in Taiwan, which are required to meet 4% additional capital buffer requirements with their Common Equity Tier 1 capital in the four years after designation. The 4% additional capital buffer includes a 2% additional regulatory capital buffer and a 2% bank's internal capital buffer.

Systemically important banks in Taiwan are required every year to submit their contingency action plans for dealing with situations where the capital is not sufficient. They are also required to conduct and report two-year stress test results to the FSC.

Five banks are currently designated as systemically important banks: CTBC Bank, Cathay United Bank, Taipei Fubon Commercial Bank, Mega International Commercial Bank, and Taiwan Cooperative Bank.

In response to the COVID-19 pandemic, the requirements of banks' internal capital buffer and the contingency action plans of the systemically important banks were postponed by one year, to 2021.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

#### Principal Means of Resolving a Failing Bank

The FSC may take over a bank if any of the following occur:

- there is a concern that a bank might not be able 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 was so graded. However, if a bank is ordered by the FSC to undertake capital restructuring or a merger within a prescribed period and fails to do so, 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.

If the FSC places a bank in receivership, the duties and powers of the bank's shareholders' meeting, board of directors, directors, supervisors and audit committee shall be suspended. The receiver as appointed by the FSC has the power to manage the bank's business and to dispose of the bank's properties.

The FSC has the power to resolve failing banks in an orderly manner. In local practice, seven banks were placed under receivership from 2006 to 2008. The FSC divided their assets into non-performing assets and other assets, and sold them separately. The non-performing assets were sold to asset management companies while the other assets were sold to other banks, with a certain amount of compensation agreed to be paid by the FSC. The depositors, employees and non-deposit creditors suffered little hurt.

**FSB Key Attributes of Effective Resolution Regimes**

Following the crisis management guidance under the FSB Key Attributes of Effective Resolution Regimes, systemically important banks in Taiwan are required every year to submit their contingency action plans for dealing with situations where the capital is not sufficient. They are also required to conduct and report two-year stress test results to the FSC. However, there is no special resolution regime for systemically important banks in Taiwan.

**Insolvency Preference Rules Applicable to Deposits**

If the failing bank is ordered by the FSC to cease its business operations, deposit debts shall precede non-deposit debts.

## 10. Horizon Scanning

### 10.1 Regulatory Developments

**"Open Banking"**

Taiwan banks are adapting to the "Open Banking" trend. The FSC encourages banks to voluntarily open up their application programming interfaces (APIs) for programmatic access by third-party financial service providers (TSPs). The ultimate goal is to provide TSPs with open access to consumer banking, transaction and other financial data from banks and non-bank financial institutions through the use of APIs.

**Three-Phase Approach**

The FSC adopts a three-phase approach for open banking:

- Phase I: product and service data (open data);
- Phase II: customer data; and
- Phase III: transaction data.

***Phase I***

Phase I was launched in October 2019. As of March 2020, 25 banks have offered access to information on banking products and services to TSPs, such as deposit interest rate, foreign exchange rate information, location of branches and loan product comparison. No personal data provided by customers is available at this stage.

***Phases II and III***

Phases II and III involve access to customer data and the processing of transactions. In Phase II, information on bank accounts and applications for bank products will be made available. In Phase III, the open API functions will include bill payment, fund transfer, credit card rewards redemption, loan repayment, etc.

As the complexity and risk of releasing personal data and transaction data of customers increase, and the technology to support, monitor and secure the open API access is more complex and critical, the timelines to launch Phases II and III are under discussion.

**Consumer Protection**

The FSC emphasises that banks must (i) collaborate with TSPs with sound management and security controls; (ii) establish internal policies and procedures; and (iii) apply the risk-based approach to use their own authentication methods for bank customers. In order to ensure consumer protection, the Bankers Association of the Republic of China is discussing the internal self-regulatory rules for banks' partnering TSPs, including security, authentication and authorisation.

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# Trends and Developments

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### "Digital-Only" Banks

In 2018, Taiwan's financial regulator, the Financial Supervisory Commission (FSC), promulgated relevant regulations governing the establishment of "digital-only" banks, which are defined as banks without physical branches. It is generally anticipated that the establishment of digital-only banks would encourage cross-industry combinations and fintech applications for everyday life by building a fintech ecosphere.

Following the promulgation of these regulations, three applications to set up digital-only banks were filed with the FSC in early 2019, all of which were approved by the FSC on 30 July 2019. According to news reports, the digital-only banks expect to receive the operating licence from the FSC by the end of 2020 and, at the inception, will first conduct consumer banking business only.

The FSC has been researching the supervision of digital-only banks as they are about to start operations, focusing on topics such as real-time monitoring of liquidity risk and other important matters of digital banks, as well as the introduction of subtech (supervisory technology) and regtech (regulatory technology) into the supervision and surveillance of digital banks' business activities.

### Bank's Outsourcing and Cloud Services

In Taiwan, a local bank's outsourcing must comply with the Regulations Governing Internal Operating Systems and Procedures for the Outsourcing of Financial Institution Operation ("Banks Outsourcing Regulations"). Only the activities enumerated in the Banks Outsourcing Regulations can be outsourced (subject to relevant requirements such as supervision of the outsourced party, the required content in the contract with the outsourced party, etc), and the outsourcing of some activities would require prior approval from the FSC.

With the development of cloud technology, the FSC evaluated the need for the adjustment of existing regulations, and in September 2019 revised the Banks Outsourcing Regulations to adapt to the growing trend of banks outsourcing to cloud service providers.

Pursuant to the amended Bank Outsourcing Regulations, prior approval from the FSC is required if the operations to be outsourced by a bank involving cloud-based services are considered "material" or if the operations are outsourced to an overseas service provider. Furthermore, when the outsourcing involves cloud-based services, the bank must, among other things:

- ensure appropriate diversification of cloud service providers;
- retain full ownership of the data outsourced to cloud service providers; and
- ensure the location for processing and storage is within Taiwan (with certain exceptions).

The digital transformation trends and the need for cost management are likely to result in growing market demand for cloud services in the foreseeable future.

### Virtual Currencies

Cryptocurrencies (digital currencies or virtual currencies based on blockchain technology) – which are not linked or tied to a government-issued currency of any nation – are currently not accepted as currencies by Taiwan's central bank, the Central Bank of the Republic of China (Taiwan) ("Central Bank"). In December 2013, both the Central Bank and the FSC expressed the government's position toward bitcoin by issuing a joint press release ("2013 Release"), in which the two authorities held that bitcoin should not be considered not as a currency but as a highly speculative digital virtual commodity. This also means that digital currencies such as bitcoin should not be considered financial products regulated by the FSC. However, in 2014 the FSC issued another press release, ordering that local banks must not accept bitcoin/virtual currencies nor provide services related to bitcoin/virtual currencies (such as exchanging bitcoin for fiat currency). Since then it is generally understood in the banking industry that banking operations should not involve bitcoin or other cryptocurrencies.

However, although cryptocurrencies are not legal tender and are not subject to financial regulations (except for those cryptocurrencies that have the nature of securities, which are known as "security tokens"), Taiwan's amended Money Laundering Control Act (the AML Act), effective from 7 November 2018, has brought cryptocurrency platform operators into the local anti-money laundering (AML) regulatory regime. In this regard, it was reported that, according to ex-Chairperson of the FSC Mr Koo, the FSC will regulate AML compliance for cryptocurrency platforms and exchanges under the AML Act after the Executive Yuan (Taiwan's cabinet) officially authorises the FSC as the regulator of AML compliance for cryptocurrency platforms and exchanges. However, at the time of writing, the Executive

Yuan has not yet granted such authorisation to the FSC, and it is unclear at this stage what requirements the FSC may impose on cryptocurrency platforms and exchanges.

While AML compliance measures for cryptocurrency businesses are yet to be clarified, in general practice, when a local cryptocurrency platform operator wishes to open corporate bank accounts for business operations, such operator would normally be required to engage a third party expert (such as a law firm) to look into such operator's internal rules and policies and standard operating procedure, to ensure it is operating on a real-name transaction basis as required by the local bank for the purpose of AML requirements.

Since the AML Act generally requires supervised entities to implement their own internal AML guidelines and procedures and submit them to the regulator for recordation, it is expected that compliance costs will rise for crypto-asset trading platforms and exchanges once AML requirements for crypto businesses are announced.

### Central Bank Digital Currency (CBDC)

According to public information from the Central Bank, the Central Bank has set up a special task force on the study of CBDC, which is generally considered to be digital New Taiwan Dollar (NTD). The CBDC task force has already completed an exploratory project on the feasibility of issuing a "wholesale CBDC" (ie, the CBDC used by financial institutions), with the preliminary observation that a platform built with DLT (distributed ledge technology) does not necessarily perform better than a platform with a centralised system. The Central Bank has announced that it started the next-step experiment project on a "retail CBDC" (ie, CBDC for use by the general public) in September 2020, and expects to complete the project in two years.

As the issuance of CBDC, the digital NTD, will affect people's payment habits (eg, as opposed to payment with cash, credit cards or other payment services rendered by payment service companies), it is generally discussed that the issuance of CBDC might have a material impact on the current banking industry as well as e-payment industry players, so it is suggested that industry participants closely follow the CBDC development as well as the results of the Central Bank's relevant projects.

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# UK

## Law and Practice


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## Contents

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# 1. Legislative Framework

## 1.1 Key Laws and Regulations

UK financial services legislation is a mixture of UK and European Union (EU) legislation, reflecting the UK's historic position as a member of the European Union until January 2020.

The Financial Services and Markets Act 2000 (FSMA) is the primary UK statute governing the financial services sector in the UK, defining the role and purpose of the regulatory authorities. FSMA has been subsequently significantly amended following the financial crisis of 2008-09 to introduce changes (such as the UK Senior Managers Regime and bank ring-fencing requirements) to enhance the resilience of the UK financial services sector.

FSMA makes it a criminal offence to undertake regulated activities by way of business – or (in broad terms) to promote financial services or products – in the UK unless duly authorised or exempt. The list of regulated activities that a bank may undertake is set out in the FSMA (Regulated Activities) Order 2001 (RAO). Exclusions exist, which (in broad terms) permit wholesale activities to be undertaken into the UK by foreign banks without obtaining authorisation.

Separate UK legislation governs the provision of payment services (the Payment Services Regulations 2017), and the issuance of electronic money (the Electronic Money Regulations 2011).

A significant proportion of UK banking regulation is derived from EU directives and regulations.

FSMA and the secondary legislation and regulators' rulebooks made under it implement a number of European law directives into UK law. European regulations, which are directly applicable, are the other key source of UK legal requirements for UK banks, including the Capital Requirements Regulation (Regulation (EU) 575/2013 (CRR), which implements the revised Basel Accord), the Market Abuse Regulation (Regulation (EU) 596/2014) and the Markets in Financial Instruments Regulation (Regulation (EU) 600/2014 (MiFIR)).

The UK left the EU on 31 January 2020 (Brexit) and is currently in the implementation period, which is due to end on 31 December 2020 (IP Completion Date or IPCD). Post-IPCD, EU law will cease to apply in the UK: the EU regulations referred to above, and other EU-derived legislation, will be incorporated into UK law as they apply at that date and amended to render them fit for purpose in their new context under the EU Withdrawal Act 2018. This is colloquially referred to as "onshoring" (see the UK Trends and Developments chapter).

The UK operates a "twin peaks" system of financial regulators, with two principal regulators – the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – each with its own rulebook. Additionally, the Bank of England (BoE) acts as the resolution authority, and has the primary regulatory responsibility for dealing with failed banks.

The PRA is the prudential regulator for banks, and the FCA regulates banks' conduct. The PRA has a statutory objective to promote the safety and soundness of the institutions it regulates, with a view to ensuring the stability of the UK financial system. The FCA's strategic objective is to ensure that the UK's financial markets function well. The FCA is responsible for regulating a wide variety of regulated firms and activities, including investment services, payment services, retail lending and insurance distribution.

The BoE also operates a Financial Policy Committee, which is the UK's macro-prudential regulator responsible for the regulation of the broader UK financial system from a macro-economic perspective. The Financial Policy Committee has power to make recommendations to the FCA and PRA in certain cases.

# 2. Authorisation

## 2.1 Licences and Application Process

Section 19 of FSMA prohibits persons from carrying on regulated activities by way of business in the UK, unless duly authorised or exempt.

Regulated activities include deposit-taking. This is triggered if money received by way of deposit is lent to others, or if the conducting of any other activity of the person accepting the deposit is financed out of the capital of, or interest on, money received by way of deposit.

Lending is generally not regulated in the UK, with the exception of various activities relating to home finance and consumer credit activity. A number of activities relating to derivatives, securities or fund units are also regulated activities, including dealing, advice, portfolio management and custody, as is insurance distribution.

The UK operates a universal banking regime, meaning that (with limited exceptions for ring-fenced banks) banks can obtain authorisation to conduct any financial services except for writing insurance and the management of funds (each of which is reserved to specific classes of regulated entity). A firm authorised for deposit-taking is also permitted to provide payment services and issue e-money.

Pre-IPCD, EU providers benefited from so-called "passporting" rights under various EU directives, enabling them to provide services or establish branches in the UK. Post-IPCD, passporting rights cease to apply and EU firms will require a UK licence in order to be able to continue to undertake regulated business in the UK (subject to a temporary permissions regime (known as the TPR), under which they are deemed authorised for a temporary period), or will need to operate outside the territorial scope of the UK regime.

A bank looking to establish itself in the UK must obtain authorisation by applying for a so-called Part 4A Permission under FSMA, which will permit it to take deposits and conduct any other regulated activities within the Permission. The application is made to the PRA and FCA (the PRA acts as lead regulator), and requires the submission of extensive and detailed information about the institution, including the completion of a permissions table that sets out in detail the permissions applied for (per type of activity and client type). It is advisable for the applicant to liaise with the PRA in the pre-application phase.

In addition to the application forms, an applicant firm must also provide the following:

- a regulatory business plan complete with a business rationale;
- information about the ownership structure of the bank;
- evidence of sufficient financial and non-financial resources;
- information regarding the management structure; and
- information about the institution's financial standing as well as its capacity to comply with its regulatory requirements via internal monitoring.

The application will be reviewed by, and subject to the approval of, both the PRA and the FCA.

In reviewing an application for authorisation, the FCA and the PRA will assess the applicant against the threshold conditions for authorisation, which include the following requirements:

- that the applicant has its headquarters or a branch in the UK;
- that the applicant conducts its business in a prudent manner and possesses sufficient non-financial and financial resources;
- that it be fit and proper to conduct regulated activities in the UK; and
- that it be capable of being regulated and supervised by the FCA and the PRA.

The PRA and FCA must make a decision on the suitability of the applicant within a six-month period beginning from the date on which they receive a completed application form. The regulators also have the power to request further information, which resets the start of the six-month period, meaning that the licensing period, in practice, can extend to up to a year.

The application fee is non-refundable regardless of the outcome; if successful, the bank must then pay an annual fee to either the FCA or the PRA, the cost of which varies based on what type of bank the applicant is looking to set up, and the revenue the bank generates. Retail consumer banks also need to pay fees levied by the Financial Ombudsman Service (FOS) and Financial Services Compensation Scheme (FSCS). Licences granted to banking institutions are theoretically indefinite, albeit with the caveat that the PRA has the power to suspend the licence at any point, as well as impose fines, where the bank fails to comply with the regulatory framework.

# 3. Control

## 3.1 Requirements for Acquiring or Increasing Control over a Bank

Under Section 178 of FSMA, any person intending to acquire or increase their level of control of a UK-headquartered bank must provide written notice of such to the PRA (no requirement applies to foreign banks with a UK branch). Prior to the acquisition taking place, the PRA requires a 60-day window to elapse, or approval to be given before the 60 days is up, before the transaction can be completed. In this context, the meaning of "control" is defined as shareholding and/or voting rights.

This requirement is triggered by the acquisition of a holding that equates to 10% or more of the total shareholding or voting rights in a UK-authorised person, or a parent of that authorised person, or share or voting power that would enable the exercise of significant influence over the authorised person. A person's "control" includes indirectly held voting power and is aggregated with the control of another with whom he is acting in concert.

An increase in control is deemed to have occurred whenever the percentage shareholding or voting rights crosses the 20%, 30% or 50% threshold, or if the authorised person becomes a subsidiary as a result of the acquisition. Likewise, a reduction in shareholding or voting rights at those same thresholds triggers a reporting requirement to provide the PRA with written notice; failure to comply with either of these obligations is a criminal offence.

In assessing an application, the PRA will consider a number of factors, including:

- the applicant's reputation and the reputation of anyone who will exert significant control on the bank's direction;
- the applicant's financial position;
- the ability of the bank to comply with the prudential requirements; and
- the risk that the acquisition has any connection to financing terrorism or facilitating money laundering.

There are no restrictions on the foreign ownership of banks in the United Kingdom, subject to applicable financial sanctions requirements at a UK, EU or United Nations level.

# 4. Supervision

## 4.1 Corporate Governance Requirements

The Companies Act 2006 provides the general basis for the general duties of directors of UK companies. Regulated firms are subject to additional requirements, reflecting the need for high-quality governance in the banking sector.

The PRA Fundamental Rules and FCA Principles establish high-level standards with which banks must comply, designed to protect the interests of customers and the wider economy as a whole. In particular, the PRA Fundamental Rules include requirements that a firm must have effective risk strategies and risk management systems (Fundamental Rule 5), and that a firm must organise and control its affairs responsibly and effectively (Fundamental Rule 6). These high-level requirements are supplemented by the General Organisational Requirements Part of the PRA Rulebook, which implements a number of more detailed organisational requirements under the European regulatory framework under the revised Capital Requirements Directive (CRD IV) and Markets in Financial Instruments Directive (MiFID II). These include requirements for a robust governance framework, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility, for effective processes to identify, manage, monitor and report risks, and internal control mechanisms, and for the management body to define, oversee and be accountable for the implementation of governance arrangements that ensure effective and prudent management.

The FCA and PRA rules are also supplemented by EU Delegated Regulation 2017/565 as regards organisational requirements and operating conditions for investment firms, which imposes more detailed requirements around the compliance, risk and internal audit functions, outsourcing and management of conflicts of interest.

Senior management and personnel are required to be not only sufficiently experienced in their field, but also of sufficiently good repute, in order to ensure the prudent and sound management of the bank. The bank must ensure that it has two employees who qualify as such, and that at least two of these individuals should be independent in their formulation of ideas and the bank's policies.

Additionally, diversity must be taken into account when selecting management members; regulators must be notified of the composition of the management team, and changes made to it; management must have adequate access to information about the bank's operations; and the effectiveness of the bank's operations must be monitored and periodically assessed, with steps taken to remediate problems.

The UK framework includes added requirements for significant firms, such as obligations to have a separate chair and CEO, and to have separate board risk, nomination and remuneration committees.

Further requirements apply to UK banks that are UK listed or subject to the UK ring-fencing rules under the UK Corporate Governance Code's principles of good governance, as overseen and maintained by the Financial Reporting Council.

## 4.2 Registration and Oversight of Senior Management

The Senior Managers and Certification Regime (SMCR) was implemented in March 2016 in the wake of the financial crisis, as a response to a perceived lack of personal accountability amongst individuals working in the financial sector. The SMCR aims to encourage responsibility amongst employees at all levels, and to improve conduct and encourage clear demarcation of responsibility. The SMCR is broken up into three separate regimes.

The Senior Managers Regime (SMR) focuses on individuals performing defined senior management functions (including executives, the chief risk officer, the head of the finance function, the heads of key business areas and the head of compliance). They must obtain approval from the regulator to perform senior management functions at their firm, regardless of whether they are physically based in the UK or overseas. Firms must assess whether senior managers are fit and proper to perform their roles both at the outset (including by taking references) and thereafter. Senior managers are also subject to the "duty of responsibility", which requires them to take reasonable steps to prevent breaches of regulatory requirements in their area(s) of responsibility from occurring or continuing. Each regulator sets out a list of prescribed responsibilities that must be allocated among the senior managers, with the intent that senior managers are accountable to the regulators for those responsibilities. UK banks are also required to maintain a management responsibility map describing the firm's management and governance arrangements, including reporting lines and the responsibilities of senior staff.

The Certification Regime focuses on individuals who are deemed by the regulator to pose a threat to the firm or its customers, by the nature of their role (certified persons). Examples of roles that are denoted as such include individuals who give investment advice, or bear responsibility for benchmarks. Certified persons are not "pre-approved" by the regulator, but instead their employers must seek certification that they are fit and proper both at the start of their employment (including by taking references) and annually on a rolling basis.

The Conduct Rules are high-level expectations of all staff involved in the running of the bank. They apply to senior managers, certified persons and almost all other employees of the firm, with the exception of those who perform ancillary functions.

### 4.3 Remuneration Requirements

UK remuneration requirements have been set in accordance with the EU provisions set out under CRD IV, subject to limited additional restrictions implemented following the financial crisis of 2008. The requirements are set out in remuneration codes of the PRA and FCA, and apply differently depending on the nature of the firm and its activities. UK banks are subject to both the PRA and FCA Remuneration Codes.

Groups in the UK must apply the Remuneration Codes to all their regulated and unregulated entities, regardless of their geographic location. Subsidiaries of UK banks in third countries must also apply the Remuneration Codes to all subgroup entities, including those based outside the UK. The Remuneration Codes also apply to UK branches of third country firms.

Some requirements of the Remuneration Codes apply universally to all employees, such as those limiting variable pay or termination payments, whereas others only apply to staff classified as "Code staff". Code staff are employees who are either senior managers or "material risk takers", individuals engaged in control functions, and any individual whose total remuneration places them in the same remuneration bracket as senior managers. If an individual is classified as Code staff but satisfies the requirements for the "de minimis" concession, certain requirements of the Remuneration Codes can be relaxed. The de minimis concession is satisfied by an individual who has a total remuneration package that does not exceed GBP500,000 in a performance year, and where variable pay does not make up more than 33% of that total package.

Under the Remuneration Codes, various principles are applicable to an employee's pay ("remuneration", including all forms of salary and benefit payments, including in kind benefits). A bank must set an appropriate ratio between fixed and variable pay. The Remuneration Codes include bonus cap rules that cap variable pay at 100% of fixed remuneration (or 200% with shareholder approval). At least 50% of variable pay should be in equity, equity-linked or equivalent instruments, and at least 40% of variable pay (or 60% where variable pay is particularly high) must be deferred and vested over a period of three to seven years. Banks are also required to adjust non-vested deferred amounts to reflect outcomes.

Limits are also placed on guaranteed bonuses, which should be exceptional and limited to new staff, and on contract termination payments, to ensure these do not reward failure.

Finally, banks must also implement policies and procedures to ensure that Code staff do not engage in personal investment strategies that undermine the Remuneration Codes' principles, such as insurance or hedging against the risk of performance adjustment.

The requirements in the Remuneration Codes are subject to a proportionality rule, which provides that when establishing and applying the total remuneration policies for its Code staff, a firm must comply with the requirements in a way and to an extent appropriate to its size and internal organisation, and the nature, scope and complexity of its activities. The expectations of the PRA and FCA regarding firms' application of the proportionality rule is based on their "relevant total assets", divided into three levels. Level 1 is for firms with total assets exceeding GBP50 billion, averaged over three years. Level 1 firms will need to apply the Remuneration Codes in full, and are subject to an annual supervisory process that involves pre-approval of remuneration awards. Level 2 firms are those with total assets between GBP15 billion and GBP50 billion, averaged over three years. Firms at this level are also obliged to apply the rules in full, but will only be reviewed on a discretionary basis. Level 3 firms are those with less than GBP15 billion in total assets on average over a three-year period, and may dis-apply the "pay-out process rules" and the bonus cap as a result.

## 5. AML/KYC

### 5.1 AML and CTF Requirements

The UK is a member of the Financial Action Task Force (FATF), which is an international, intergovernmental task force (not a formal international body) set up and funded by the G7 and other members to combat money laundering and terrorist financing.

The primary legislation governing AML requirements in the UK is the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the MLR). These are supported by extensive non-statutory guidance given by the Joint Money Laundering Steering Group, which sets out what is expected of banks and staff in relation to the prevention of money laundering and terrorist financing. The principal elements of the MLR are requirements to conduct risk assessments associated with money laundering and terrorist financing, and to apply risk-based customer due diligence policies, controls and procedures, calibrated to the type of customer, business relationship, product or transaction, and taking into account situations and products which by their nature can present a higher risk of money laundering or terrorist financing; these specifically include correspondent banking relationships, and business relationships and occasional transactions with politically exposed persons.

The FCA requires that firms give overall responsibility for the anti-money laundering operations of a firm to a director or senior manager, who is responsible for being aware of the money laundering risks and taking steps to effectively mitigate them. A Money Laundering Reporting Officer must also be appointed, as the keystone of the firm's anti-money laundering procedures.

In January 2020, the UK government enacted the Money Laundering and Terrorist Financing (Amendment) Regulations 2019, which was the legislative instrument designed to implement the European Union's Fifth Anti-Money Laundering Directive (5MLD). The UK, in fact, has opted to exceed the requirements set out under the EU legislation, as part of its push to maintain its role as a world-leading financial centre.

The updated regulations extended the scope of the persons subject to the MLR, extended the customer due diligence requirements, created bank account portals that can be accessed by financial intelligence units and national regulators, and created a system of registration for crypto-asset businesses.

FATF issued a statement in April 2020 discussing the impacts of COVID-19 on financial crime, and the increased risks emerging in particular areas. FATF particularly highlighted the risks of fraudulent investments and phishing scams during the pandemic period. FATF is also adjusting its expectations in relation to firms, if they are able to demonstrate a reduced risk of money laundering or terrorist financing. One such concession has been allowing simplified due diligence measures, alongside the postponement of mutual evaluations and follow-up assessment deadlines in high-risk jurisdictions.

## 6. Depositor Protection

### 6.1 Depositor Protection Regime

The Financial Services Compensation Scheme (FSCS) is the UK compensation fund available to customers of a majority of UK financial services firms. Its purpose is to provide a backstop in case of the failure of a regulated financial institution, paying compensation up to certain limits when the institution in question in unable to pay claims against it, or is likely to become unable to do so. It is the UK's depositor compensation scheme, but also covers other classes of regulated business, including insurance and investment business.

The failure of a bank, the insolvency of an insurer, or the provision of negligent advice causing loss to a consumer by a financial adviser are all examples of potential justified causes for making a claim for compensation. The extent to which a claimant will be compensated in the event of a successful claim varies depending on the nature of the claim.

The regulatory rules applicable to the FSCS's depositor protection arrangements are largely set out in the Depositor Protection module of the PRA Handbook. This provides that the FSCS must pay compensation in respect of an eligible deposit with a defaulted UK bank or foreign bank with respect to its UK branch deposits. For protected deposits, including retail deposit accounts, compensation is capped at GBP85,000, subject to a higher cap of GBP1 million for certain temporary high balances (such as a balance associated with home sales and purchases). Certain classes of depositor are ineligible for compensation, including banks, investment firms, insurance undertakings, financial institutions and certain funds.

To support the need for the FSCS to be able to make rapid payout in respect of banks in default, the depositor protection rules are supplemented by extensive requirements to ensure that banks can provide the FSCS with the requisite information to make compensation payments. These are centred around the so-called Single Customer View, which is a dataset made available to the FSCS to enable it to identify clients and their claims in order to be able to identify and fund compensation payments.

The FSCS primarily operates under Part 15 of FSMA, which sets out the governance of the scheme, as well as the capacity of the FCA and PRA to make rules in relation to the FSCS. The scheme is officially managed by Financial Services Compensation Scheme Ltd, operating as a guarantee-limited company.

The scheme is principally funded via fees and levies charged to participating firms. These costs include the management expenses levy (broken up into yearly base cost running fees, and specific costs for particular funding classes) and the compensation costs levy, which is primarily a result of the costs incurred by the FSCS in paying out compensation.

Firms participating in the scheme are typically allocated into one or more funding classes, decided on the basis of the regulated activities they perform. The amount each firm is obliged to pay is based on which of these funding classes they have been placed in, up to a maximum amount per funding class each year. If a firm were to fail, and there was insufficient funding available from the other institutions in that funding class, the costs would be pooled across all the funding classes through a mechanism known as the FCA retail pool.

## 7. Bank Secrecy

### 7.1 Bank Secrecy Requirements

The UK does not have a specific statutory regime regulating banking secrecy, but instead relies on the common law duty of confidentiality between the customer and bank, borne from their contractual relationship. Common law provides that the bank has a duty of confidentiality to the customer, as an implicit term of the contract.

The duty of confidentiality from a bank to its customer broadly covers all information about the customer that is held by the bank. The case of Tournier v National Provincial and Union Bank (1924) established that the duty expressly covers the credit or debit balance of the customer's account, all transactions made through the account, and the securities given in respect of the account.

This duty of confidentiality also extends beyond the lifetime of the account, continuing to apply after it is no longer active or even closed. It further extends to information that is held by the bank about the customer that is from a source other than the customer's own account, if the acquisition of this information was an indirect result of the customer holding that account.

The bank's duty to the customer is not absolute; there are a number of exceptions to the duty established in Tournier that allow a bank to divulge information in certain circumstances. Information may be disclosed by the bank if the customer has provided their express or implied consent to the disclosure, if the bank is legally compelled, if there is a public duty, or if the disclosure would protect the bank's own interests.

If a customer has agreed, however, to express terms in their contractual relationship with the bank to permit disclosure in particular situations, then this agreement would take precedence over Tournier. Regulators also have some additional specific powers in relation to compelling bank disclosure; the FCA has statutory powers to require certain disclosures, as does HMRC (the UK's tax authority) in respect of tax. Likewise, if there are reasonable grounds for suspicions of money laundering or terrorist financing, banks may be compelled to co-operate in providing information under AML and CTF legislation.

When the FCA or PRA requires a disclosure to be made by a bank to its investigators as part of an ongoing investigation, it is subject to a statutory obligation of confidentiality with respect to the information, subject to limited "gateways" permitting disclosure in certain circumstances.

As the duty of confidentiality is a common law regime, rather than a statutory one, a breach of contract or a breach of common law is the potential result of a bank failing to observe the customer's rights. The customer may seek an injunction, even preemptively, in order to prevent a breach, or to restrain or avoid a repetition of something previously disclosed. The customer may then also seek damages potentially for a breach of contract, presuming that there are express confidentiality provisions, or for a common law breach of the duty of confidentiality.

## 8. Prudential Regime

### 8.1 Capital, Liquidity and Related Risk Control Requirements

As a member of the G20, the UK has implemented the Basel Accord. The principal legislation implementing the Accord is CRD IV and the CRR, which apply the Accord to all banks and certain investment firms. The EU and UK are at an interim stage of implementing the Basel III package: a number of elements are still to be implemented in the UK, including the Fundamental Review of the Trading Book, the revisions to the Standardised Approach to risk-weighting, the Net Stable Funding Ratio, elements of the Leverage Ratio, changes to the large exposures regime, and changes to the treatment of exposures to funds and central counterparties.

All authorised banks are subject to PRA Rule 4, requiring institutions to hold and maintain adequate financial resources. UK banks are additionally subject to detailed risk management, capital and liquidity requirements that do not apply to non-UK banks, with the exception of some risk management requirements, which apply at branch level.

#### Risk Management

A bank must be able to identify, manage, monitor and report actual or potential risks through adequate risk management policies and procedures and risk assessments. Specific risks that a bank must plan for include credit risk, market risk and liquidity risk, but also less apparent sources of risk such as operational risk, residual risk, group risk and reputational risk.

A bank must establish and maintain an independent risk management function implementing its policies and procedures and reporting to or advising senior personnel accordingly. The risk control arrangements should (where appropriate considering the bank's size, nature and complexity) include a chief risk officer (CRO) and a board-level risk committee.

The CRO should, among other things, be accountable to the board, be fully independent of business units, have sufficient stature and authority to execute the responsibilities, and have unfettered access to any part of the bank's business that impacts its risk profile. The CRO is expected to report to the chief executive, chief finance officer or other executive directors.

A risk committee should be headed by a non-executive director and be composed mainly of non-executive directors. The risk committee oversees and challenges the bank's risk monitoring and management, and advises the board on risk strategy and oversight. A bank's internal control mechanisms and procedures must permit verification of its compliance with rules adopted under CRD IV and CRR at all times.

### Capital Requirements

The CRR imposes capital requirements on UK banks in the form of risk-weighted asset and leverage requirements.

Risk-weighted asset capital requirements oblige a bank to maintain regulatory capital ratios by reference to a bank's "total risk exposure amount", which weights the accounting value of a bank's assets and credit exposures according to their potential to suffer loss.

Regulatory capital comprises Tier 1 capital (comprising Common Equity Tier 1 (equity) and Additional Tier 1 (equity-like hybrid capital instruments)) and Tier 2 capital (deeply subordinated debt). Common Equity Tier 1 capital is the highest quality capital, generally comprised of ordinary share capital and reserves. Additional Tier 1 capital is the next level of quality of capital, comprised of perpetual subordinated debt instruments or preference shares that must automatically be written down or converted into CET1 if the bank's CET1 ratio falls below a specified level. In practice, the PRA generally expects that this level is at least 7%. Tier 2 capital is capital that is of an insufficient quality for CET1 or AT1, and is comprised of subordinated debt or capital instruments with an original maturity of at least five years, meeting specific criteria.

The Pillar 1 minimum capital requirements that currently apply to UK banks under CRD IV require the following:

- a base regulatory capital of at least 8% of the total risk exposure amount;
- Tier 1 capital (comprising CET1 capital and AT1 capital) of at least 6% of the total risk exposure amount; and
- CET1 capital of at least 4.5% of the total risk exposure amount.

These are supplemented by buffer requirements. Pillar 2A captures those risks against which banks must hold capital and that are not eligible under the Pillar 1 regime. This includes the combined buffer, formed of a capital conservation buffer of 2.5% of the total risk exposure amount, a countercyclical buffer (recently cut to 0% as part of the COVID-19 mitigation policies), a buffer for global and other systemically important institutions, and a systemic risk buffer for banks subject to UK ring-fencing requirements. Pillar 2B, or the PRA buffer, takes into account a bank's ability to withstand severe stress, alongside perceived deficiencies in its risk management and governance framework, as well as any other information deemed relevant by the PRA.

In determining risk-weighted assets, the bank's assets and liabilities are divided into the trading book and non-trading book. In determining capital requirements in the non-trading book, banks may follow the standardised or (with PRA approval) internal ratings-based approach. Capital requirements in the trading book comprise counterparty credit risk and market risk, position risk, equity risk, commodities risk, foreign exchange risk and risk associated with options and collective investment schemes. As with the non-trading book, the rules contemplate a variety of methods of calculating risk-weighted asset requirements. The risk-weighted asset requirement also includes a metric for operational risk.

### Leverage Ratio

Unlike the risk-weighted assets ratio, the leverage ratio is non-risk sensitive. The leverage ratio is not yet binding under the CRR, but the PRA has implemented the leverage ratio to be a binding metric in the UK for systemic UK banks, requiring that a bank's Tier 1 capital exceed 3.25% of its total assets and off-balance sheet exposures. The PRA has also issued firm-specific countercyclical buffer and additional leverage ratio buffer requirements for such banks.

### MREL

The Bank of England also regulates the minimum requirement for own funds and eligible liabilities (MREL) found in Directive 2014/59 on bank recovery and resolution (BRRD), and has also implemented the FSB's standards on total loss-absorbing capacity (TLAC) through the MREL framework. The BoE has issued a policy statement establishing its approach to MREL. The quantum of the MREL requirement depends on the resolution strategy of any given bank, which in turn depends on its size and the nature of its activities. The largest UK banking groups are expected to issue MREL that broadly equate to either twice their risk-weighted asset or leverage capital requirements, whichever is higher.

### Liquidity Requirements

All UK banks are subject to liquidity requirements implementing the Basel III liquidity coverage ratio, which came into force in January 2015. It is designed to ensure that banks hold a buffer of unencumbered, high-quality, liquid assets in order to meet modelled outflows in a 30-day stress test scenario. The presumption in this scenario is that the institution's management will be able to take suitable actions to correct the course in that period.

High Quality Liquid Assets (HQLA) are cash or assets that can be converted into cash quickly with limited or no loss in value. An asset can be deemed an HQLA for the purposes of the liquidity requirements if it is unencumbered and meets the minimum liquidity criteria, and if the firm is able to demonstrate that it can be quickly converted into cash if required. HQLA are divided into Level 1 and Level 2 assets, based on their likely liquidity. Level 1 assets include only the most liquid – including cash – central bank reserves, and certain securities that have the backing of a sovereign government or a central bank.

There is no limit on the quantity of Level 1 assets a bank can hold, as these are preferable from a regulatory perspective. Level 2 assets include particular government securities, covered bonds, corporate debt securities and residential mortgage back securities. A firm must hold no more than 40% of its total liquid asset pool in Level 2 assets. Under the CRR, except for periods deemed to be crises, a UK bank must maintain a liquidity buffer equal to at least 100% of its anticipated net liquidity outflows over a 30-calendar day stress period – where the total net outflows must not exceed the total HQLA pool over the period of the stress testing upon the bank.

The requirements also compel UK banks to regularly report their liquidity data to the PRA, with retail funding reports and systems and control questionnaires being reported quarterly, marketable assets and funding concentration reports being reported monthly, mismatch reports and pricing data being reported weekly, and the underlying liquidity of the bank being reported daily. Liquidity requirements apply on a solo and consolidated basis. The PRA can waive the application of the requirements on a solo basis, but is unlikely to do so other than in relation to sub-groups of institutions authorised in the UK. UK banks are, therefore, generally not able to rely on liquidity from non-UK subsidiaries to satisfy UK liquidity requirements.

## 9. Insolvency, Recovery and Resolution

### 9.1 Legal and Regulatory Framework

The UK has implemented the FSB Key Attributes of Effective Resolution Regimes. A bank incorporated in the United Kingdom may be wound up under the general insolvency law applicable to UK companies, or wound up or resolved under the special resolution regime (SRR) under the Banking Act 2009. The UK regulatory framework also provides for recovery and resolution planning to enhance the resilience and resolvability of UK banks and banking groups: the MREL requirement described under **8.1 Capital, Liquidity and Related Risk Control Requirements** also supports resolution by ensuring that firms have sufficient capital or liabilities available for recapitalisation in resolution, where appropriate.

### Insolvency

Banks have special protections from insolvency proceedings, with only the Bank of England, PRA or the Chancellor of the Exchequer able to apply for the court order required under Section 94 of the Banking Act. The application to the court would be made on the basis that the bank is either unable to pay its debts, or is likely to become unable to do so, and that the winding-up of the institution would be just and equitable. In order for the application to be made to the court in the first place, the PRA must be satisfied that the trigger conditions of failure or likely failure have been met, and the BoE must be satisfied that it is not reasonably likely that the situation will be reversed. Separately, the Chancellor of the Exchequer can apply on the grounds that the winding-up of the bank would be in the public interest.

### Recovery and Resolution Planning

Consistent with the requirements of the BRRD, UK banks are required by the PRA to produce and maintain recovery plans, along with resolution packs, in order to reduce the risk that the failure of a UK bank could threaten the broader market or require government intervention in the form of taxpayer money being used for a bailout.

The PRA and BoE introduced a resolution assessment framework for major banks in 2019, which supplements the recovery and resolution framework by requiring banks to undertake an assessment of their resolvability, submit it to the PRA and publish a summary of the assessment thereafter. The initial reporting and disclosure dates under the framework have been deferred to October 2021 and June 2022 as a result of the COVID-19 crisis.

### Resolution

The SRR gives the UK authorities powers to resolve a failing bank (or banking group company). It consists of five stabilisation options:

- transfer to a private sector purchaser;
- transfer to a bridge entity;
- an asset management vehicle tool;
- a bail-in tool; and
- transfer to temporary public sector ownership.

It also includes a modified bank insolvency procedure that facilitates the FSCS in providing prompt payout to depositors or transfer of their accounts to another institution, and a bank administration procedure, for use where there has been a partial transfer of business from a failing bank.

The SRR tools may only be deployed where a bank is failing or likely to fail, where it is not reasonably likely that action will be taken that would result in the bank recovering, and where the exercise of resolution powers is in the public interest. In exercising the stabilisation powers, the resolution authority (generally the BoE, though temporary public ownership is reserved to HM Treasury) is required to have regard to a number of resolution objectives, including ensuring the continuity of banking services, depositor and client asset protection, financial stability and the need to avoid interfering with property rights.

On entry into resolution, the SRR requires the BoE to write down equity and write down or convert other capital instruments into common equity. The BoE has discretion to select the appropriate resolution tool to apply to resolve the bank. The main resolution tools are:

- bail-in – the write-down of the claims of the bank's unsecured creditors (including holders of capital instruments) and conversion of those claims into equity as necessary to restore solvency to the bank, which is intended to be applied to large banks;
- transfer to a private sector purchaser or bridge bank – the transfer of all or part of a bank's business to another bank or to a temporary bank controlled by the BoE, which is intended to be applied to smaller banks; and
- finally, the modified insolvency regimes for the smallest banks.

Nationalisation is also provided for within the SRR framework as a last resort.

The regime carries with it a number of ancillary powers to enable the transfer of property, to stay default and other rights, and to take other action supporting resolution. Because these potentially affect property and other rights, the framework includes a number of safeguards, including a "no creditor worse off" provision designed to ensure that creditors and other stakeholders in the process are no worse off as a result of the resolution than they would have been had the bank been put into liquidation at the point of the resolution.

### Insolvency Preference

Consistent with the BRRD, the UK insolvency framework includes depositor preferences. These prefer covered deposits (deposits protected by the FSCS). Eligible deposits (deposits by persons eligible for FSCS coverage over the FSCS limit), and deposits made by natural persons and micro, small and medium size enterprises that would be eligible deposits if they were taken in the UK are subordinate to covered deposits but rank ahead of other senior claims.

# 10. Horizon Scanning

## 10.1 Regulatory Developments

### Brexit

The United Kingdom officially left the European Union at 11pm on 31 January 2020, but for financial services regulation this milestone was more representative of the beginning of the process, rather than the end. The UK left the EU in name only, entering a transitional period in which virtually all of the existing rights and obligations that the UK benefitted from and observed as a Member State remained in place. This meant that the system of financial passporting continued to be available, the absence of which is one of the largest concerns for major UK and European financial institutions in the Brexit process. As it stands, the transition period is set to end on 31 December 2020, triggering the loss of passporting rights and the "onshoring" of the EU acquis into UK law. These are described in more detail in the **UK Trends and Developments** chapter.

### Implementation of the EU Risk Reduction Package

The implementation process for EU regulatory reform under the so-called risk reduction package is ongoing, with a number of changes requiring implementation in late December 2020 under BRRD (BRRD2) and to CRD IV (CRD V) and CRR (CRR2) (implementing Basel III). Because these precede IP Completion Date, the UK government is implementing them in accordance with its EU law obligations. The changes cover governance, remuneration, buffers and reporting by branches of third country banks under CRD V, as well as a number of changes relating to recovery and resolution planning and related issues under BRRD2, some of which will lapse on IP Completion Date.

### Future Financial Services Changes

Following exit, the UK will cease to implement or adopt new EU financial services legislation. The UK government also decided not to onshore "in flight" EU legislation – ie, EU legislation that has been passed but has not yet fallen due for implementation as at IP Completion Date. As it is common for major EU legislation to be implemented over a horizon of years, this means that the UK is inheriting swathes of unfinished legislation, which will need to be completed. Notably, this includes remaining changes under the EU risk reduction package as well as various markets regulatory changes. To fill this gap, the UK government has introduced a Financial Services Bill which will, among other things, provide regulatory powers to the PRA to revoke relevant parts of the CRR and make rules to implement the remaining Basel III changes. It is currently anticipated that the relevant changes will be implemented by year end 2021.

It is also suboptimal to operate a financial regulatory system based on inherited EU legislation. In acknowledgment of that suboptimal approach, HM Treasury has published a consultation paper on the financial services future regulatory framework review. The aim of the review is to examine how the UK should adapt its approach to regulation outside of the EU, building on the strengths of the existing UK framework. Central to the proposed approach is the adaptation of the regulatory model introduced by FSMA.

HM Treasury considers that the current FSMA regulatory framework, as adapted to address the regulatory failures of the 2008-09 financial crisis, continues to be appropriate. The consultation paper goes on to state that the framework resulting from the onshoring of retained EU law under the European Union (Withdrawal) Act 2018 (please see the **UK Trends and Developments** chapter of this guide for more detail) will not provide the optimal, long-term approach for UK regulation of financial services. Among other things, it highlights that maintaining this approach would lead to a fragmented rulebook, with regulatory requirements spread across a range of sources, including domestic and retained EU legislation, regulators' rules and onshored EU technical standards.

The proposals set out in the consultation paper seek to provide a clear-cut and coherent allocation of regulatory responsibility. The government and Parliament would set the policy framework for financial services and the strategic direction of financial services policy. Working within that framework, the regulators would design and implement the regulatory requirements that apply to firms, using their expertise and agile rule-making powers to ensure that the regulation is well designed and keeps pace with market developments. Enhanced scrutiny and public engagement arrangements would help to ensure that the regulators are accountable for their actions and stakeholders are fully engaged in the policy-making process. The consultation runs until the start of 2021, and the responses will help develop a final package of proposals that HM Treasury will consult on during 2021.

Running in parallel to HM Treasury's consultation, the House of Commons Treasury Committee has also launched a new inquiry into the future of financial services in the UK after the Brexit transition period ends. Among other things, the Committee will examine how financial services regulations should be set and scrutinised by Parliament, and will consider the government's financial services priorities when it negotiates trade agreements with third countries. It will also consider how regulators are funded and the extent to which financial services regulation should be consumer-focused.

### COVID-19

As if the prospect of Brexit had not caused sufficient strain on the financial services sector, 2020 has seen the COVID-19 virus shut down economic activity across the globe, and has brought with it an unprecedented change to modern working environments. In September 2020, the FCA published its annual report, three months later than usual owing to the circumstances of the pandemic, which highlighted the regulator's policy adjustments and guidance in the present circumstances.

The FCA outlined its five main priorities in its COVID-19 response, which were to support customers through the immediate crisis shock, to keep markets functioning and orderly during a major repricing event, to issue emergency guidance, to maintain public access to essential financial services, and to protect society's most vulnerable. For firms, the FCA introduced policies that allowed forbearance on best execution reporting, and extended deadlines around the upcoming implementation deadlines for the SMCR.

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# Trends and Developments

***Contributed by:***
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## Brexit: Introduction

The UK stands on the threshold of the most major change to its financial markets in living memory. The UK officially left the European Union at 11pm on 31 January 2020 under the withdrawal agreement, under Article 50 of the Treaty on European Union (the Withdrawal Agreement), subject to a transitional period in which the UK has remained in the single market. The transitional period ends on 31 December 2020 (IP Completion Date), shortly after the time of writing, either with a free trade agreement agreed between the parties, or without. At that time, the UK will cease to be a member of the single market and – regardless of whether or not a free trade agreement is reached – the complex network of European single market rights upon which UK market participants rely to conduct business into the EU, and vice versa, will fall away. This has highly significant implications for firms conducting business across the English Channel (or Irish Sea) as, generally speaking in the UK and most EU Member States, conducting business without an appropriate licence or passport is often an offence.

## UK and EU Access Post-Exit

From a regulatory perspective, the effect of the exit will be asymmetric. Since the Brexit vote, UK regulators have prepared a host of measures to alleviate the so-called "cliff-edge" effects of market participants ceasing to have single market rights. Notably, this has included providing for temporary permissions regimes for EEA firms, permitting them to continue to conduct regulated activities in the UK post-exit; providing relief permitting European financial products, including funds and securities, to be sold into the UK; and recognising most classes of European financial infrastructure, in order to enable UK market participants to have continued access to clearing and other market infrastructure. By contrast, the EU has taken only very limited steps to mitigate the effect of the exit: the UK's clearing houses and central securities depositary are to benefit from temporary recognition to give EU participants continued access to them, but UK banks, investment firms, insurance companies and financial market infrastructure have no relief, making cross-border business from the UK off-limits in many cases. Some individual EEA states have also implemented their own transitional regimes in order to facilitate UK financial firms continuing to provide their services in those jurisdictions, but this is far from being a satisfactory solution for continued market access. This asymmetry has rendered international banks' UK operations largely redundant as a means to access EU markets, and in turn has resulted in a rush on the part of UK and international financial institutions to create licensed subsidiaries in the EU – most typically in Germany, Ireland, France, Luxembourg or the Netherlands – or in a few cases to limit or close EU business.

A further bone of contention between the EU and UK is equivalence. The EU legislative framework confers preferential treatment on non-EU actors in a number of areas, based on the concept of equivalence. One might expect that the UK would be able to benefit from equivalence, starting from the position of an integrated regime for financial services with the EU. Such an expectation would fail to anticipate the use of equivalence as a political tool to further domestic interests. While the Political Declaration that accompanied the final Withdrawal Agreement envisaged that the UK and EU would "endeavour" to find an agreement on equivalence for financial services by 30 June 2020, that agreement has not eventuated. In August 2020 an executive vice-president of the European Commission, Valdis Dombrovskis, stated that Brussels was not sufficiently prepared to assess whether the UK qualifies for some pan-EU equivalence provisions, because the EU's own regulations are uncertain. By contrast, the UK has generally granted equivalence with respect to EU market participants.

## Onshoring EU Legislation into UK Law: Background

In addition to the loss of EU market access, UK banks and UK branches of international banks face considerable domestic legislative and regulatory upheaval as a result of Brexit. In advance of the agreement and ratification of the Withdrawal Agreement, to plan for the possibility that the UK could exit the EU without a Withdrawal Agreement (a hard Brexit), the UK government passed the European Union (Withdrawal) Act 2018 (EUWA) as a contingency measure. The principal purposes of the EUWA were to repeal the European Communities Act 1972 and to provide a functioning statute book from the date of exit from the EU (Exit Date) in order to ensure that legal certainty, continuity and stability would be retained as the UK exits the Single Market. Following the UK ratification of the Withdrawal Agreement, the EUWA was amended by the European Union (Withdrawal Agreement) Act 2020 (EUWAA) in order to enact the Withdrawal Agreement.

As amended, the EUWA performs a number of functions, including:

- repealing the European Communities Act 1972 (ECA) with effect from Exit Day, but continuing to subject the UK to EU law for the duration of the Implementation Period;
- converting EU law as it stands at the IP Completion Date into domestic law and preserving laws made in the UK to implement EU obligations;
- creating temporary powers to make secondary legislation to enable corrections to be made to the laws that would otherwise no longer operate appropriately once the UK has left the Single Market at the end of the Implementation Period;
- bringing to an end the jurisdiction of the Court of Justice of the EU in the UK; and
- providing for Parliament's oversight of the outcome of the government's negotiations with the EU on the Withdrawal Agreement and the framework for the future relationship between the EU and the UK.

Absent further legislation, EU law would cease to apply in the UK upon the repeal of the ECA, leaving the UK without much of its legal framework. In order to avoid this consequence, the EUWA provides for the retention of most EU law as it stands on the IP Completion Date, by incorporating it as a freestanding body of domestic law. The EUWA also sets out rules that govern how onshored law can be modified or repealed, and by what type of conventional domestic legal instrument.

### Making Onshored EU Law Fit for Purpose

It will be obvious that merely to "cut and paste" EU law into the UK statute book would not be workable: multiple changes would be needed – for example to eliminate single market rights, replace European with domestic bodies, and make consequential changes to references to EU law. To deal with this, Section 8 of the EUWA gives ministers of the Crown a power to make secondary legislation to deal with any failure of retained EU law to operate effectively or any other "deficiency" in retained EU law that would arise upon exit, and to sub-delegate the power to a public authority where it is best placed to deal with the deficiencies – for example, the Bank of England (BoE), the Prudential Regulation Authority (PRA) and/or the Financial Conduct Authority (FCA) (as applicable) in the context of financial services.

With respect to financial services regulation, responsibility for exercising the powers conferred by Section 8 falls to HM Treasury (HMT), which has made more than 70 statutory instruments (SIs) to "onshore" EU legislation in the financial services sector. In recognition of the role the UK regulators have historically played in shaping the EU's binding technical standards (BTS), HMT delegated powers to amend the European regulatory technical standards (RTS), implementing technical standards (ITS) and delegated regulations to the FCA, BoE, PRA and/or the Payment Systems Regulator (PSR), subject to the oversight of HMT. The instruments which the regulators may use to correct deficiencies in existing BTS are called EU Exit Instruments. The regulators are also granted the power to make BTS in the future, which they will do by way of standards instruments. The FCA, PRA and BoE have each published numerous EU Exit Instruments to address their respective areas of responsibility.

### Relief from Changed Legal and Regulatory Obligations

The approach taken by HMT to onshoring has been to treat EU market participants as third country participants under onshored law, reflecting the loss of single market rights and the EU treating UK market participants in the same way. Although the resultant changes made by the onshoring process are largely technical, they carry with them a host of potentially material changes for financial market participants – for example, risk weights of exposures of UK banks to EU banks would change. With industry wondering how to prepare for the potential change in obligations, HMT brought forward legislation to allow regulators to grant some flexibility in applying new legislative requirements under the EUWA. The power enables the UK regulators to amend the effect of the onshored EU legislative rule-set in order to provide temporary relief from changes to pre-exit practice.

This has been done in Part 7 of the Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019, which provides that the FCA, PRA and BoE may direct that "relevant obligations" are not to apply to particular entities or to apply in a different way, in each case for up to two years after the IP Completion Date. These directions provide for a "standstill" of relevant obligations, which for this purpose are obligations (as contained in an Act of Parliament or subordinate legislation) that begin to apply or apply differently in relation to which the regulator has responsibility for supervising or ensuring compliance. Each transitional contains a list of exclusions – these are obligations which the regulators expressly do not submit to a standstill.

The regulators have each communicated their intention to use their transitional powers broadly.

The PRA and FCA are expected to issue final forms of the transitional directions in late 2020.

### "Must Do" Obligations and General Relief

In February 2019 the FCA issued a statement indicating seven areas where it expected UK firms to take action in advance of a hard Brexit. The FCA's exercise of its standstill powers at that time was (and remains) relatively narrow, with large numbers of legal changes not being within the scope of the standstill directions.

Following feedback from industry that the FCA's approach left considerable uncertainty about UK firms' obligations which were neither subject to standstill nor within the seven areas, on 1 October 2020 the FCA published an updated statement of its expectations for UK firms, setting out 13 areas in which the FCA considers it would be inconsistent with its statutory powers to use its transitional power and in respect of which it expects UK firms to be preparing to comply from the end of the Implementation Period (colloquially referred to as "must do" obligations). The statement provides that the FCA expects firms to undertake "reasonable steps to prepare to meet the new obligations by 31 December 2020." The FCA went on to say that it would "not take a strict liability approach and [did] not intend to take enforcement action against UK Firms and other regulated entities for not meeting all requirements straight away, where there is evidence they have taken reasonable steps to prepare to meet the new obligations by 31 December 2020."

Critically, the FCA has indicated that it will not require UK firms to implement other onshored substantive legal obligations for which it is responsible by year end; UK firms will have until March 2022 to implement these, except where non-compliance is found to give rise to "serious and foreseeable harm". This effectively means that UK firms can defer the implementation of other legislative and regulatory changes that come into force on 1 January. This is referred to as "general relief".

However, even at this late stage, the FCA does not intend general relief to apply to those obligations that are subject to ongoing discussions over equivalence. HMT and FCA have provided equivalence or relief for the purposes of many of the areas of onshored law – but questions remain over the derivatives trading obligation (DTO) under the onshored Markets in Financial Instruments Regulation, in particular.

### Where Does This Leave Firms?

The complexity of interpreting the onshoring process means that firms will need to prepare themselves adequately for the changes not just on the horizon, but in the immediate future. This will include needing to identify the relevant statutory instruments or exit instruments that act to onshore the legislation, understand the substantive and cumulative changes the relevant instrument makes, identify and assess how the transitional provisions affect timing and whether the relevant legislation contemplates equivalence decisions, and, where it does, track and assess whether HMT has made equivalence decisions.

Additionally, firms will need to track regulators' standstill powers where regulators have joint standstill powers, and, where a standstill power applies prima facie, assess whether the exemptions to the standstill direction apply. The regulation of financial services covers a broad spectrum of legislation, and even firms with a seemingly narrow focus will need to be alert to changes across multiple subsectors.

UK regulated firms are largely resigned to, and prepared for, the loss of their single market rights, but operationalising new EU operations will still continue to give rise to short-term and medium-term challenges for many. The onshoring of EU legislation will run to a similar time horizon: firms face some short-term challenges immediately following the IP Completion Date as thousands of pages of EU financial services legislation change simultaneously, subject in large part to transitional relief. The real work will just have begun, however: the lapse of transitional relief in 2022 and wholesale changes to the onshored regulatory regime that are likely to be made in order to revitalise the UK sector will be more challenging.

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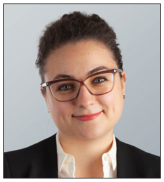

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