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UK Banking Regulators and Foreign Banks: A Vision of Future Supervision

The U.K.'s banking regulator, the Prudential Regulation Authority (PRA) recently published a consultation paper on its approach to supervising international banks (the Draft Supervisory Approach). A link to the PRA document is here: PRA consultation.

This is an important consultation because the U.K. serves as an international financial services centre, which hosts branches from 145 EU[1] and non-EU banks (international banks) accounting for a third of the U.K. banking system's assets. The U.K. economy is dependent on the financial services sector's success, but the financial crisis raised a number of issues for U.K. regulators and politicians to deal with:

- The banking crises in Iceland and Cyprus demonstrated that the EU's system of deposit protection insurance is only as strong as the country where the international bank is headquartered. As an example, the U.K. taxpayer had to bail out U.K. depositors in Icelandic banks in order to help preserve U.K. financial stability;

- A blanket "subsidiarisation policy" requiring banking groups from specific countries to set up U.K. subsidiaries rather than branches can reduce the U.K.'s attractiveness as a financial centre even though it may reduce overall systemic risk. The subsidiaries have to absorb extra regulatory capital and funding costs which a U.K. branch would avoid. Therefore, non-EU international banks may look to establish branches in another EU country which does not apply a rigid subsidiarisation policy;

- The U.K. also is bound by EU single market directives that require it to host branches of banks from other EU countries once the bank has complied with its home country formalities. This reduces the U.K.'s freedom of manoeuvre and leaves the U.K. taxpayer exposed to the risk of the EU sovereigns repudiating banking system liabilities to U.K. depositors in times of crisis.

The PRA's Draft Supervisory Approach gives an indication on how U.K. banking regulators will tackle some of these issues. We expect that the PRA's Draft Supervisory Approach once implemented will have the following effects:

- **International banks from non-EU countries applying recognized international regulatory standards and intending to conduct "non-critical" wholesale activities should find it relatively straightforward to set up and maintain a U.K. branch.**

  The PRA will assess the "equivalence" of the regulatory standards maintained by the non-EU international bank's home banking regulator, the adequacy of the current resolution regime in place and the credibility of the bank's resolution plan. The PRA will look to satisfy itself that the interruption of the U.K. branch's services would not be critical and would not result in uncertainty and financial instability.

1 For the purposes of this alert the EU means the 28 member states of the European Union together with Iceland, Norway and Liechtenstein who have agreed to implement EU legislation.

The PRA will be given significant flexibility in applying these criteria. However, the PRA statement, when read with a recent speech made by the governor of the Bank of England, indicates a more welcoming U.K. approach to international banks. This does not mean a return to pre-financial crisis "light touch" regulation. The PRA will continuously assess and supervise non-EU international banks to ensure that a branch structure remains appropriate.

- **Non-EU international banks wishing to conduct retail banking through a U.K. branch will find it harder to do so and may be forced to set up a U.K. subsidiary.**

  The Draft Supervisory Approach contains no formal prohibition on non-EU international banks conducting retail banking operations through U.K. branches. However, the PRA has said that it will require a very high level of assurance on resolution arrangements if a branch is to conduct anything more than a de minimis level of retail banking operations. It also expects new non-EU branches to focus on wholesale banking. The PRA's cost benefit analysis indicates that a proportion of the 49 non-EU banks with current U.K. branch office retail operations will need to set up U.K. subsidiaries.

- **Non-EU international banks conducting wholesale business through a U.K. branch will be subject to different levels of regulation depending on where they are headquartered and the significance of their operations.**

  The PRA has outlined high-level criteria to assess the equivalence of the regulatory standards maintained by the non-EU international bank's home banking regulator. It is reasonable to assume that the banking regulatory standards in most OECD countries will be deemed equivalent, and that the relevant banking regulators will enter into agreements with the PRA on the division of supervisory responsibilities. However, where a country's regulatory regime is deemed non-equivalent or no inter-regulator agreement can be reached then the PRA may ask the relevant bank to take steps to convert its U.K. branch into a subsidiary.

  Assuming an equivalence assessment and an inter-regulator agreement, the PRA is likely to maintain an energetic supervisory style, involving a close liaison with banking groups and regulators in respect of significant U.K. branches and their resolution plans. The PRA envisages a varied approach, which ranges from the acceptance of assurances from non-U.K. regulators on resolution in some cases to the PRA's own review of a non-U.K. banking group's resolution plans in others.

- **Some EU international banks with passported U.K. branches also will experience a more vigorous supervisory approach.**

  The EU Capital Requirements Directive gives EU banks headquartered in one EU member state (the home state) the right to set up a branch in another. The "passporting" process avoids the need for the EU bank to go through a lengthy authorization process in the EU country in which it wishes to establish a branch. The directive makes clear that prudential supervision is the responsibility of the home state regulator, with the exception of liquidity supervision. Therefore, EU law restricts the PRA's ability to intervene directly in the prudential supervision of a U.K. branch of a bank from another EU country.

  Nevertheless, the PRA has indicated that it will take steps to identify significant branches and seek to influence the prudential supervision of those branches, especially in the area of resolution plans.

The consultation period closes on 27 May 2014. Internationally active banks with U.K. operations should consider the Draft Supervisory Approach's potential impact.