Regulation of Financial Institutions

Dr Thomas Walford

Ausaf Abbas

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Who are we?

- Thomas Walford – Duncan Lawrie, Royal Bank of Canada & Bank Leumi.
- Ausaf Abbas – Merrill Lynch & Morgan Stanley.
- Expert Evidence International – provides expert witnesses in international financial litigation.

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Contents of this Lecture

1. General Regulatory Principles.
2. The US.
3. The UK.
4. Regulated Services.

Areas we will Cover

1. The international regulatory environment as it applies to banks and financial institutions.
2. Prudential Regulation v Financial Services Regulation.
3. The regulation of lenders (including regulated mortgages and payday lenders).
4. The regulation of investment managers and private banking.
5. The operation and regulation of investment banks in international markets.

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International Regulatory Environment

Banks used to operate in an unregulated manner but:

1. Bank failures were common;
2. Economies were adversely effected;
3. Innocent individuals lost substantial sums of money.

It used to be possible to form a bank as one would any other type of company.

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So why do we have Banking Regulation?

Governments realised:

1. Orderly financial markets were vital to the operation of a healthy economy.
2. Governments needed to provide a deposit protection system to preserve confidence in the retail market place.

International Regulatory Environment

There are three parts to Banking Regulation

1. Licencing;
2. Supervision;
3. Enforcement & Discipline.

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International Regulatory Environment

Banking Regulation seek to cover:

1. Capital Requirements;
2. Reserve Requirements;
3. Corporate Governance;
4. Reporting and Disclosure;
5. Credit Rating;
6. Large Exposure Restrictions;
7. Activity and Affiliation Restrictions.

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Capital Adequacy

The Basel III requirements from the Bank of International Settlements (BIS)

- Developed in response to Global Financial Crisis of 2008.
- With higher levels of capital, and better quality capital, banks are better able to tolerate financial stress.
- Applies to Systemically Important Financial Institutions (SIFIs) on a global basis and subject to intensive stress testing.

Capital Adequacy

- Capital adequacy measures a bank’s capital in relation to risk-weighted assets (‘RWA’);
- Capital Adequacy Ratio: (Tier 1 + Tier 2)/RWA;
- Under Basel III the minimum capital adequacy ratio banks must maintain is 8% of its Risk Weighted Assets (RWA). Also introduced Minimum Leverage Ratios;
- Two types of capital: Tier 1 (core capital) and Tier 2 (secondary capital).

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International Regulatory Environment

The $64million Question: Do you aim for "too big to fail" banks?

- A few banks are easy to monitor and make sure that there is a controlled and orderly banking market; or
- Many banks mean that the loss of any one does not necessarily put the financial markets at risk.

International Regulatory Environment

All countries developed their own brand of banking regulation. They came about in different ways and at different times.

- Several international bodies;
- Then we are going to look at two major financial markets:
  1. The US;
  2. The UK.

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International Regulatory Environment - International

Financial Action Task Force – (‘FATF’)

- Accepted by 200 Countries;
- FATF establishes international standards to combat Money Laundering (AML) and the financing of terrorism:
  - Grey List – Increased monitoring (Albania, the Bahamas, Barbados, Botswana, Cambodia, Ghana, Iceland, Jamaica, Mauritius, Mongolia, Myanmar, Nicaragua, Pakistan, Panama, Syria, Uganda, Yemen and Zimbabwe)
  - Black List – North Korea and Iran.

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International Regulatory Environment - International

International Organisation of Securities Commissions ('IOSCO')

A set of common conduct of investment business principles was established in 1990 by IOSCO and is recognized as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities' regulation. It works intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda. IOSCO is based in Madrid, Spain.

https://www.iosco.org/

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International Regulatory Environment - International

EU Financial Services Rules

- Applies across Europe via a set of directives and laws enacted in each country.
- Applied to the UK, but not since Brexit.

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International Regulatory Environment - US

- Things started to change after major financial banking disasters.
- First major country to introduce regulation was the US through providing Deposit Insurance via the FDIC through the Banking Act of1933 (aka Glass-Steagall).

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International Regulatory Environment - US

- Deposit Protection via the Federal Deposit Insurance Corporation ('FDIC')
- Consumer Protection and Banking activity by Federal Reserve Board and the Truth in Savings Act (1991)
- Currency Control via Office of the Comptroller of the Currency

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International Regulatory Environment - US

- Also strict regulation concerning Anti-money laundering and anti-terrorism via the Banking Secrecy Act of 1970.
- By product was to avoid tax evasion.

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International Regulatory Environment - US

- Investment Business – regulated by Securities and Exchange Commission ('SEC').
- The primary purpose of the SEC is to enforce the law against market manipulation.
- SEC enforces the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes–Oxley Act of 2002, and other statutes

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International Regulatory Environment - UK

- In the UK up until 1973 permission from the Dept of Trade & Industry was necessary, but only as a formality.
- Then granting permission was transferred to the Bank of England.
- In 2000 it was then transferred to a specialist regulator called the Financial Services Authority ('FSA').

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International Regulatory Environment - UK

Today: In the UK regulation is managed by the Bank of England and is covered by the:

- Prudential Regulatory Authority ('PRA'); and
- Financial Conduct Authority ('FCA').

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International Regulatory Environment - UK

Prudential Regulatory Authority (‘PRA’)

1. Tailored supervision.
2. Being forward looking.
3. Focusing on the bigger picture.

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International Regulatory Environment - UK

Financial Conduct Authority (‘FCA’):

1. Detailed supervision of 58,000 firms.
2. Covers banks, mutual societies, investment managers, financial advisors etc.
3. Deposit Protection via FSCS.
4. Payments System Regulator.

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International Regulatory Environment - UK

Lending:

1. In general lending is done between consenting adults.
2. Loan governed by a loan agreement specifying terms, interest rate etc.
3. Some duty of care by the financial institution but a low bar.

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International Regulatory Environment - UK

- Specialist Lending:
  1. Mortgages;
  2. Payday Loans;
  3. Retail Lending.
- Strong requirements to Treat Customers Fairly – see TCF Rules introduced in 2008.

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International Regulatory Environment - UK

Investment Management and Financial Advice:

1. Regulated by the FCA.
2. Rules conducted laid out in the Conduct of Business Sourcebook ('COBS').

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International Regulatory Environment - UK

One of the most important concepts is “Client Categorisation”:

1. Market Counter Parties;
2. Professional Clients (per se and elective);
3. Retail Customers.

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Commercial Banks & Investment Banks

- Important distinction, but increasingly blurred by repeal of Glass Steagall Act and the emergence of Global Universal Banks.
- Main activities of Investment Banks:
    - Investment Banking
    - Debt (Sales, Trading & Capital Markets)
    - Equity (Sales, Trading & Capital Markets)
    - Asset Management
    - Wealth Management
    - Research

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Regulation of Investment Banks in US

- Securities Exchange Act 1934 introduced to regulate securities exchanges and broker-dealers .
- Investment Company Act and Investment Advisers Act established in 1940.
- After the GFC of 2008, Dodd-Frank reforms introduced a plethora of new regulation of financial institutions.

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Regulation of Investment Banks in UK

- Historical separation of commercial banking and investment banking not so prevalent in the UK.
- Both areas are covered by the Financial Services and Markets Act 2000 (‘FSMA’).
- UK regulatory framework considerably influenced by various European laws, which will change in the future due to Brexit, despite regulatory alignment.

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Q&A

We welcome your questions

Expert Evidence International Limited
www.expert-evidence.com
+44 20 7884 1000

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