

The legal and regulatory framework behind personal current accounts

Annexe A of Personal current accounts in the UK - an
OFT market study

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Summary

A.1 This annexe considers in more detail the legal regulatory framework in relation to the provision of personal current accounts (PCAs) in the UK. PCAs are provided by banks and building societies. This Annexe looks at:

- what is a bank?
- what is retail banking?
- what is a building society?
- what is a current account?
- what is the nature of the relationship between banks and PCA customers?
- how are banks and building societies regulated in the UK?
- what additional existing and future legal protections are there for PCA customers?

What is a bank?

A.2 The business of banking can be divided into a number of sectors, including retail banking, merchant banking, operations in the wholesale money markets, and the business of foreign banks. For our purposes only retail banking is relevant.

A.3 Because each banking sector has different characteristics, in law there is no one overall definition of 'banking' that distinguishes banks from other financial institutions.

A.4 At common law the starting point in defining a bank was as an institution engaged in the business of banking. This meant that the courts when defining an institution as a bank would review its business and compare it with that transacted by banks generally.

A.5 The courts have adhered to three key principles when defining a bank, firstly that the meaning of 'banking business' can change over time – although traditionally it has been held to include accepting money on deposit from customers for the purpose of making a profit, by re-investing it, and the opening of current accounts operated by cheques and collecting sums paid in by customers. Secondly 'banking business' in one place is not necessarily regarded as such in another place. Thirdly if an institution is generally (by reputation) considered to be a bank, a court is likely to consider it to be a bank too.

A.6 The Court has defined 'banking business' as containing two characteristics¹:

- acceptance of money from and collection of cheques for their customers and placing them to the customers credit, and
- honouring cheques drawn on the bank by its customers and debiting customers' account accordingly.

A.7 These two characteristics carry with them a third, namely to keep current accounts or similar in which credits and debits are entered.

A.8 These three types of business form the essence of banking at common law, though the methods of making debits and credits have evolved over time.

A.9 The meaning of 'banking' has also been set out variously in legislation, including the Banking Act 1979, then the Banking Act 1987 and, most recently, under the Financial Services and Markets Act 2000 (FSMA 2000).

A.10 Article 5(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001² made by HM Treasury under section 22 FSMA 2000 sets out that:

'Accepting deposits is a specified kind of activity if –

(a) money received by way of deposit is lent to others; or

¹ *United Dominions Trust V Kirkwood* [1966] 2 QB 431- Lord Denning

² S.I. 2001, No. 544, as amended.

(b) any other activity of the person accepting the deposit is financed wholly, or to a material extent, out of the capital of or interest on money received by way of deposit.'

A.11 Where the term 'bank' or 'banking' was not defined in legislation pre-1979 the common law definition was used.

What is retail banking?

A.12 PCAs are part of the business of retail banking. The major retail banks are also traditionally described as the clearing banks. Currently the 'big five' clearing banks, are Barclays, HSBC, Lloyds TSB, Royal Bank of Scotland and Halifax Bank of Scotland. There are a number of smaller clearing banks operating throughout the UK. These include Abbey, Clydesdale Bank, Co-operative Bank, Alliance and Leicester Commercial Bank, Northern Rock and Ulster Bank.

A.13 The supermarkets and other retail chains that now provide banking and other financial services (for example Tesco, Sainsbury's, Marks and Spencer, and Virgin often do so through a joint venture with an established clearing bank. The internet banks are also usually linked to established banks as a means of gaining access to clearing services. For example, Cahoot and Smile are part, or divisions of existing clearing banks.

A.14 As the Competition Commission (CC) has noted, there is no settled definition of a clearing bank.³

A.15 Broadly the clearing process a) identifies whether a customer that wants to make a payment (for example by way of cheque) has enough money in his account so that the payment can be made or the bank is willing to advance money on overdraft, and b) transfers the funds from the payer's account to the payee's account. In the case of cheques, this process can take several days and there are technically three clearing dates: the date when the

³ Paragraphs 2.7 and 3.13 of the CC's report: The supply of banking services by clearing banks to small and medium sized enterprises, available at www.competition-commission.org.uk/inquiries/completed/2002/index.htm

cheque is cleared for value (the date from which interest is payable); the date when the cheque is cleared for withdrawal (the date from which the money can be withdrawn); and the date when the cheque is cleared for fate (the date from which the money can no longer be taken out of your account by your bank because, for instance, the cheque paid in was fraudulent).

- A.16 The Payment Systems Task Force⁴ agreed in November 2006 that clearing times for cheques should be subject to maximum times. From the end of November 2007 changes to the cheque clearing cycle were introduced to ensure that cheques will clear for value no later than two days after they are paid in; cheques will clear for withdrawal no later than four day after they are paid in (six days for saving accounts without notice periods) and cheques will clear for fate no later than six days after they are paid in.
- A.17 Historically 'clearing banks' were those banks in the City of London that had an agreed system for clearing cheques and other paper payments through membership of the Committee of London Clearing Banks (the CLCB). The expression 'clearing bank' is still often used to denote only those banks that are members of the cheque clearing schemes in the UK.
- A.18 In 1985 operational responsibility for clearing cheques and other paper payments was taken over by the Association for Payment Clearing Services (APACS). Over time, however, alternative clearing systems have developed and access to them has opened up.
- A.19 There are currently several clearing systems in operation in the UK. These include:
- The Cheque and Credit Clearing Co. Ltd (CCCCL) which provides a clearing service for paper payments such as cheques and paper credits in England, Wales and Scotland.

⁴ The Payment Systems Task Force was established in 2004 to identify, consider and seek to resolve competition, efficiency and incentive issues relating to payment systems over four years, particularly looking at network effects of the existing payment mechanisms. The Payment Systems Task Force was wound up following the launch of a new strategic body for the payments industry in November 2006. Further information on the Payment Systems Task Force, is available at www.oft.gov.uk/oft_at_work/markets/services/payment-systems/

- The Belfast Bankers Clearing Committee (BBCC) which provides a set of rules similar to those in use by CCCCL for the exchange, processing and settlement of internal paper payments in Northern Ireland.
- BACS (formerly Bankers Automated Clearing Services), which provides a service for clearing high-volume, low-value bulk electronic payments such as direct debits, direct credits (including payment of wages and salaries, pensions and government benefits).
- CHAPS (Clearing House Automated Payment System), which provides a fast service for clearing high value sterling and euro payments.
- The Faster Payments Service, which processes, in hours rather than days, lower value electronic payments made via the internet or phone. Standard orders will now clear on the day they are sent.

In most cases a bank that is not a member of a clearing system can obtain clearing services indirectly, using a clearing system member bank as its agent for the checking and transfer of payments through the relevant clearing scheme.

- A.20 BACS operates by way of multilateral net settlement. This means that the debit and credit payments are not processed individually but are saved in the system in the course of each day. At the end of each day the total debits and credits to each bank are set off (or netted off) against each other and one debit or credit payment is made.
- A.21 Because it involves higher value payments and this increases the risks of systemic failure (insufficient funds being available to any one bank in the payment chain), the CHAPS system is a 'real time' gross settlement system. This means that the sending and receiving banks process each payment separately as it comes in.

- A.22 Before 2004 BACS, CHAPS and CCCCL were under the control of APACS, which was an umbrella body. In 2000 the Cruickshank Report⁵ concluded (among other things) that there were competition problems and inefficiencies associated with UK payment systems. This led to an OFT market study into payment systems. The OFT's recommendations included proposed governance changes to APACS and the clearing schemes. As a result, in 2004, APACS and its associated clearing schemes were restructured so that APACS and the individual schemes became legally separate bodies with separate governance arrangements.
- A.23 Even after these changes had been made there remained competition concerns. HM Treasury responded by setting up a Payment Systems Task Force, chaired by the OFT, to identify, consider and seek to resolve remaining competition efficiency and incentive issues related to payment systems.
- A.24 In November 2006, the Chancellor of the Exchequer formally gave his backing to a new governance model for the UK's payment systems industry proposed by the Payment Systems Task Force. The new governance body, the Payments Council, is open to all payment service providers in the United Kingdom (including BACS, CHAPS and CCCCL). Its role is to lead the future development of co-operative payment services in the UK to ensure that the payment system as a whole meets the needs of payment service providers, users and the wider economy. It had its first meeting in March 2007.
- A.25 In May 2008 the new Faster Payments infrastructure was launched. This followed an announcement by the Payment Systems Task Force in May 2005 that an agreement had been reached with the banking industry to reduce clearing times on phone, internet and standing order payments. The design of the new service was a joint project between Immediate Payments Ltd (a joint venture company set up by Voca and LINK), APACS and 13 founding member banks. Immediate Payments Limited provides the central infrastructure for the service. CHAPS clearing company provides the day-to-day operations and management of the service.

⁵ *Competition in UK Banking: A Report to the Chancellor of the Exchequer* Don Cruickshank, March 2000.

A.26 The Faster Payments Service enables beneficiaries of payments to access funds within a couple of hours of a payment being made. This improves on pre-existing clearing processes for electronic payments which usually take three working days.

What is a building society?

A.27 Building societies originated in the 19th century as friendly societies – when members' money was pooled into organisations from which they could borrow money to build houses.

A.28 Building societies are mutual organisations, meaning that they are owned by and run for the benefit of their members. Originally they were terminating societies, meaning that a building society was wound up when all its members had a house.

A.29 As a result of the Building Societies Act 1986 (BSA 1986) and subsequent amendments in 1988 and 1997 building societies can now provide a wide range of banking and financial services to their members, including current accounts operated by cheques drawn on the building society. The effect of the BSA 1986 as amended is to narrow the gap between banks and building societies – although there remain certain distinctions between them.

A.30 The Building Societies Association, which is the trade association for building societies, sums up the difference between a building society and a bank:

'A building society is a mutual institution. This means that most people who have a savings account, or mortgage, are members and have certain rights to vote and receive information, as well as to attend and speak at meetings. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. Each building society has a board of directors who run the society and who are responsible for setting its strategy.'

Building societies are different from banks, which are companies (normally listed on the stock market) and are therefore owned by, and run for, their shareholders. Societies have no external shareholders requiring dividends and are not companies.'

The other major difference between building societies and banks is that there is a limit on the proportion of their funds that building societies can raise from the wholesale money markets. A building society may not raise more than 50 per cent of its funds from the wholesale markets. The average proportion of funds raised by building societies from the wholesale markets is 30 per cent.'

- A.31 The major building societies now have access to membership of the clearing systems in the UK.
- A.32 Under sections 97 to 100 BSA 1986 building societies can opt to transfer their business to a commercial company – thus converting to corporate status and becoming a bank. Building societies that have recently converted from mutual associations to public limited companies and become banks include Abbey National plc, Alliance and Leicester plc, Halifax plc, Northern Rock plc and Woolwich plc.

What is a current account?

- A.33 The object of a current account is to enable the customer to pay by cheque, debit card or other transfer mechanisms amounts due from him and to arrange for the collection of cheques and other receivables payable to him. The account represents the customer's 'liquid funds' available for everyday expenditure.

The bank has three main functions in relation to PCAs:

- To pay a customer's account by honouring cheques and money transfers and debit card and cash withdrawal instructions (a paymaster function). The bank is under no duty to monitor the customer's account to ensure sufficient funds are in place to cover any payments – and has no obligation to meet a demand for payment if the customer's funds are inadequate.
- To enable customers to make deposits into their current accounts. In relation to the receipt of funds into a PCA, the bank acts as the customer's agent. This enables customers to remit cheques and other payments (e.g. salary or earnings and other electronic money transfers)

to the bank for collection on their behalf through the relevant clearing system.

- To act as lender in relation to overdrafts.

- A.34 In legal terms, money paid in by a customer amounts to a loan to the bank. That money is not held in trust or 'earmarked' for the customer: the money becomes the property of the bank, which it can use for its own purposes. In legal language the customer's money is treated as a 'chose in action'. This means that the money deposited by the customer is (intangible) property of which that customer does not have present enjoyment (possession) but that the customer has a right to recover the money on demand.
- A.35 In economic (rather than legal) terms the bank acts as a reservoir of money. This concept highlights the fact that money flowing into a bank, including through payments into PCAs, becomes part of the bank's generic fund, and that money paid out when customers make withdrawals or other payments out of their PCA again comes from the bank's central reservoir.
- A.36 This tallies with the legal concept that money paid by the customer to the credit of his account is treated as having been lent by him to the bank. As noted above, while the account is in credit the PCA customer is in the position of creditor with a right to have the bank's debt repaid to him on demand. The funds become the property of the bank. It follows that the bank is free to use the money for its own purpose and dealings. Importantly, it does not have to account to the customer for any profits it earns on the money paid in by the customer – save insofar as there is any agreement to pay interest on credit balances in the PCA.
- A.37 Although some PCAs now pay interest on credit balances, PCAs can be distinguished from savings accounts (which are outside the scope of our study) in the following ways:
- i) All savings accounts earn interest – whereas some banks do not offer interest on credit balances of PCAs.
 - ii) Cheque books, debit cards and cash cards are not issued in respect of many savings accounts whereas they are a key feature of PCAs.

- iii) A PCA may either be in credit or overdrawn. The law does not recognise that a savings account can go into overdraft.⁶ Other than any accommodation made by a bank to allow temporary debit balances while funds paid into a savings account clear, a customer that only has a savings account would need to borrow money by means of a separate personal loan.

A.38 Overdrafts on PCAs may be granted either by an arrangement between the parties – which will normally be subject to a ceiling defining the maximum amount the customer is entitled to overdraw on his account at any one time – or simply by the bank's tacit agreement to the customer drawing amounts exceeding the balance on his account. In both cases the overdraft is regarded as repayable on demand. Interest on a debit balance is calculated on a daily basis but is debited periodically, usually monthly in arrears.

A.39 Overdrafts can be distinguished from personal loans in the following ways:

- i) In the case of personal loans the advance is usually credited to the borrower's current account for him to draw on at any time, and the amount of the loan is simultaneously debited to a loan account opened in the borrower's name. With an overdraft there is no separate loan account. The customer is given a facility to create a debit balance in his current account – but payments into the current account reduce that debit balance.
- ii) Repayments on loans have to be made according to a fixed repayment schedule within an agreed loan period – though borrowers often have the right to make early repayment. In the case of overdrafts repayments are made as and when payments are made into the current account. There is no repayment schedule.
- iii) Usually amounts that are repaid on loans may not be re-borrowed, whereas overdrafts are a standing facility: money paid in can be

⁶ *Barclays Bank Ltd. V. Okenarhe* [1966] 2 Lloyd's Rep. 87, 94.

drawn out again up to the overdraft limit at any time while the overdraft arrangement is in place.

What is the nature of the relationship between banks and PCA customers?

- A.40 The relationship between a bank and its customer is largely governed by contract law. The bank mandate that a customer signs when opening an account sets out some of the terms of the contract. Other terms will either be implied or will be set out in separate written agreements between the bank and the customer, for example, relating to telephone or internet banking services or the provision of credit and debit cards.
- A.41 The Jack Committee which reported in 1989 recognised the need to 'achieve fairness and transparency in the banker-customer relationship' and for that reason it recommended the creation of the Banking Code, discussed below.
- A.42 Case law⁷ suggests that a person becomes a 'customer' of a bank (to whom the bank owes duties) at the time at which the bank agrees to open an account for the person.
- A.43 A PCA customer is entitled to terminate the relationship at any time by drawing out the outstanding funds and by closing the account. Under contract law, if a bank wants to terminate a PCA it will need to give the customer reasonable notice of termination. The Banking Code section 7.6 provides that under normal circumstances the bank will not close an account without giving the customer at least 30 days' notice.
- A.44 The essence of the contract of banker and customer is the bank's right to use money deposited or credited to the customer's account for its own purpose and its undertaking to repay an amount equal to that paid in, with or without interest, either at call or at a fixed time. The House of Lords decided, in 1848⁸, that the contract is fundamentally one of borrower and creditor. These roles are reversed when the account is overdrawn: the bank becomes the creditor, and the customer the borrower.

⁷ *Ladbroke & Co. v. Todd* [1914] 30 TLR 433, *Woods v Martins Bank Ltd.* [1959] 1 QB 55.

⁸ In the case of *Foley v. Hill* [1848] 2 HLC 28.

- A.45 By agreeing to open an account the bank agrees to execute certain monetary transactions of the customer, which include the honouring of his cheques and the carrying out of periodic payments authorised by him. The bank further agrees to collect payments due under cheques or other effects made out to him.
- A.46 Secondly, the bank agrees to act as the customer's agent in banking transactions and to exercise the degree of care and skill to be expected of a banking agent of this type.
- A.47 Thirdly, the bank owes its customer a duty of confidentiality arising out of the agency relationship – the bank agrees to act as its customer's agent in banking transactions – and, as an agent, owes a duty of loyalty and confidentiality to its customer (the principal).
- A.48 The duty of confidentiality is not unbounded and the court (in *Tournier v National Provincial and Union Bank of England*⁹) put four qualifications on the bank's duty of secrecy:
- (i) where disclosure is under compulsion of law
 - (ii) where the public interest requires disclosure
 - (iii) where the interests of the bank require disclosure, or
 - (iv) where disclosure is made at the express or implied consent of the customer.
- A.49 Although these qualifications did not, contrary to the recommendations of the 1989 Jack Committee, become codified into statute, they are contained within the Banking Code at paragraph 11.1. The banks' duties of confidentiality extend beyond the point where the account is closed.
- A.50 In certain special circumstances a bank may owe its customer fiduciary duties of loyalty and fidelity in addition to the duty of skill and competence expected under the contractual relationship. For example, a bank may have undertaken

⁹ [1924] 1 KB 461.

to act in the best interests of its customer when giving investment advice to a customer, giving rise to a relationship of trust and confidence. However, the existence of fiduciary duties is the exception rather than the rule: in normal circumstances (as the courts have confirmed) the banking activities of deposit-taking and lending are not fiduciary in character. We will not, therefore, consider fiduciary duties any further.

How are banks and building societies regulated?

- A.51 The key objectives of banking regulation are to safeguard the stability of the financial system and protect depositors from loss. Banks and building societies potentially face greater risks than other businesses, in particular because their liabilities (deposits and borrowings) are more liquid than their assets (loans and investments): in times of crisis, customers can withdraw money faster than banks can make or borrow it.
- A.52 Financial stability responsibilities relating to banking are divided between the Financial Services Authority (FSA), the Bank of England and HM Treasury (the Treasury). A 1997 Memorandum of Understanding (MOU) between the FSA, the Treasury and the Bank of England sets out a framework for co-operation between those bodies.¹⁰
- A.53 According to the terms of this agreement, the FSA is responsible for the authorisation and prudential supervision of banks and building societies. The Bank of England is responsible for the overall stability of the financial system, and the Treasury is responsible for the overall institutional framework of financial regulation and legislation. The FSA and the Bank of England are expected to alert the Treasury if a serious problem occurs.
- A.54 The OFT is responsible for regulating lending to consumers. Under the Consumer Credit Act 1974 (as amended) businesses that offer goods or services on credit or lend money or are involved in activities relating to credit

¹⁰ www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf

or hire must be licensed by the OFT. The banks that are the subject of this market study are licensed by the OFT to lend to consumers.

- A.55 On 30 January 2008 the Chancellor of the Exchequer announced the launch of a consultation 'on proposals for strengthening the current framework for financial stability and protecting depositors'.¹¹ The consultation set out five key objectives to be achieved following the recent turbulence and instability in global financial markets. These included improving co-ordination between the Treasury, the FSA and the Bank of England – through changes to the MOU. It proposes that on an operational level there would be a clearer distinction between 'normal' and 'crisis' conditions and improved external communications (applying lesson learnt from Cabinet Office Briefing Room (the mechanism by which the Government co-ordinates its response to a large scale disruptive event); greater information sharing; and clarifying responsibilities under the MOU. The consultation closed on 23 April 2008.
- A.56 The authorities are now digesting the consultation responses. At the time of going to print they had promised to publish a summary of the consultation responses and consult further, with a view to bringing forward legislation later this year. Likely content of a future Bill include measures designed to: give the Bank of England a statutory financial stability objective; revise the Bank of England's governance framework to support that responsibility, including establishing a new Financial Stability Committee within the Bank's Court of Directors; introduce a 'special resolution regime' to allow the authorities to intervene when a bank gets into severe difficulties; and improve the FSA's powers to collect information from banks in difficulties and facilitate sharing of the information with the Financial Services Compensation Scheme (FSCS)¹².

¹¹ www.hm-treasury.gov.uk/newsroom_and_speeches/press/2008/press_07_08.cfm

and

www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm

¹² Outline on the website of the Leader of the House of Commons at www.commonleader.gov.uk/output/page2432.asp, and letter of the Chancellor of the Exchequer to the Treasury Select Committee dated 19 June, at www.parliament.uk/documents/upload/Chancellor08619F.pdf

History of regulation of banks

- A.57 In the past, banks (but not building societies) were controlled informally by the Bank of England. Statutory supervision of banks and building societies came into effect with the passing of the Banking Act 1979 (BA 1979) – prompted by the secondary banking crisis of the mid 1970s (triggered by the fall in property prices) and the need to give effect to the European Community first banking directive.
- A.58 BA 1979 contained a prohibition on deposit takers from accepting deposits from the public without authorisation (or an exemption from the prohibition). The Act introduced a two-tier system of authorisation by the Bank of England, which distinguished recognised banks from licensed institutions. Categorisation was based on track-record, standing and range of activities. Recognised banks were not subject to such a wide range of statutory requirements as licensed deposit-takers.
- A.59 This distinction of institutions and the tendency of the Bank of England to supervise the licensed deposit takers more strictly than the recognised banks became the weakness of the regime and manifested in the collapse of the Johnson Matthey Bank in 1984. Johnson Matthey Bank was a recognised bank and it was noted that had the Bank had been subject to the stricter supervision of the licensed deposit takers, its difficulties would have been seen earlier.
- A.60 The issue of banking supervision was subsequently reviewed by a committee set up by the Chancellor of the Exchequer and its recommendations formed the basis of the White Paper on Banking Supervision. The intention of the White Paper was to introduce new legislation to address developments in the banking world, as well as to deal with deficiencies in the BA 1979 and the lessons learnt from the Johnson Matthey Bank affair. The Banking Act 1987 (BA 1987) contained more detailed provisions. This included a new Bank of England Board of Banking Supervision Division – which, in practical terms, gave a role to the City in banking supervision (through the appointment of independent members onto the Board). It also clarified the Bank's role by giving it a general duty to supervise the institutions it authorised. BA 1987

abolished the distinction between licensed deposit takers and recognised banks.

- A.61 Following the General Election of 1997, the new Labour government began a review of the financial services sector, including banking. This led to the Bank of England being given full operational responsibility for monetary policy and the transfer of its supervisory functions to the FSA (by virtue of the Bank of England Act 1998). The statutory regulation of banking changed with the coming into force of Financial Services and Markets Act 2000 (FSMA 2000).

History of regulation of building societies

- A.62 Building societies have been subject to statutory regulation since 1836 and are currently subject to the Building Societies Act 1986 (BSA 1986) as amended. Prior to BSA 1986, building societies' lending remained predominantly related to transactions involving the acquisition of land. In addition, building societies were restricted to dealings with individuals, and they could not provide current account facilities involving cheques drawn on the society itself. After BSA 1986, the tight control on building societies' commercial powers were relaxed to allow them to compete more effectively with banks in the more deregulated financial and mortgage markets of the 1980s. Despite these changes building societies could still only provide services which were explicitly permitted by BSA 1986. These were set out in Schedule 8 of the 1986 Act. Further deregulation took place in 1988 under the Building Societies (Commercial Assets and Services) Order 1988.
- A.63 Under BSA 1986 building societies were put under the supervision of a new supervisory body – the Building Societies Commission. Later, section 336(1) FSMA 2000, gave the Treasury the power to order the transfer of the functions of the Building Societies Commission to the FSA. This transfer was given legal effect through the Financial Services and Markets Act (Mutual Societies) Order 2001.¹³ This means that deposit-taking by building societies is now regulated by the FSA.

¹³ SI 2001/2617

A.64 In parallel, FSMA 2000 gave HM Treasury the power to order the abolition of the Building Societies Investor Protection Board, the body responsible for administering the scheme to protect investors in building societies that become insolvent. This scheme was dissolved by the Financial Services and Markets Act 2000 (Mutual Societies) Order 2001. Investors are now protected by the Financial Services Compensation Scheme, discussed below.

The Bank of England

- A.65 The Bank of England is responsible for keeping a broad overview of the financial system as a whole. Under the 1997 Memorandum of Understanding mentioned above the Bank of England has a non-statutory responsibility for overseeing the operation of payment systems, focusing on those systems whose reliable functioning is critical to financial stability. These include the clearing schemes noted above (BACS, CHAPS and CCCCL) as well as the LINK ATM network operator and the debit and credit card payment systems.
- A.66 The Bank's oversight role focuses on any weaknesses in risk management that would have the greatest potential impact on the overall financial system. The Bank also promotes efficiency in payment and settlement infrastructure.

Payment Services Directive

What are payment services?

- A.67 Payment services primarily include the services offered by banks and other financial institutions for executing cash withdrawals and receipts into and out of accounts, and for executing payments. In this context payment services do not include cash. Payment services are often provided through the medium of a payment system.
- A.68 There are two main types of payment scheme – four party systems and three party systems:

In **four party systems** two payment service providers are involved in providing payment services. Typically, these systems involve one bank providing services to the person who is making the payment (known as the 'originator' of the payment), with another bank providing a service

to the person who receives the payment (the 'recipient'). These banks may be linked by a payment scheme that connects many paying and receiving institutions (multilateral agreement) or they may be linked directly through a bilateral agreement. In the UK, inter-bank systems like BACS, CHAPS and CCCCL, and card schemes like Visa, Mastercard and Link are four party payment schemes.

In **three party systems**, one payment service provider provides services to both the originator and recipient of a payment, with the transaction travelling across the books of this one provider. In some three party payment systems, the customer may have a relationship with an agent of the payment service provider who might facilitate origination or receipt of a payment on behalf of the payment service provider. In the UK, E-money issuers like PayPal and most money remitters are three party schemes, as are card schemes like American Express.

- A.69 The European Commission believes that the fragmented nature of payment services across Europe (along national lines) is a barrier to cross-border trade. It has introduced the Payment Services Directive (PSD), which has the stated aim of making cross-border payments as easy, efficient and secure as 'national' payments within a Member State. The PSD also seeks to improve competition by opening up payment markets to new entrants, thus fostering greater efficiency and cost-reduction.
- A.70 It will do this by removing legal barriers to the provision of payment services across the EU; by ensuring that access to payment schemes is as open as possible and not just limited to clearing banks; and by introducing rules to protect consumers.

FSMA 2000

- A.71 FSMA 2000 removed separate regulation for banking and other financial services and the FSA became the sole regulator for the financial services industry.

The FSA has four statutory objectives:¹⁴

- to maintain confidence in the financial system
- to promote public understanding of the financial system
- to secure the appropriate degree of protection for consumers
- to reduce the extent to which it is possible for a financial services business, whether carried on by a regulated person or in breach of the general prohibition, to be used for a purpose connected with financial crime.

A.72 As the sole financial services regulator, the FSA has powers of authorisation, supervision, investigation, enforcement and the power to impose penalties for market abuse. It also has wide rule-making powers. It sets out the rules that financial institutions must follow in its Handbook and in accompanying guidance. The Handbook sets out rules relating to:

- high level standards, covering principles for business, senior management arrangements, the responsibilities of senior management and statutory minimum threshold standards
- prudential standards, covering capital adequacy, liquidity risk and notification requirements
- business standards, covering the conduct of business, the handling of customer assets, market conduct, training and competence, and money laundering
- regulatory processes, covering authorisations, supervision, enforcement and decision-making, and
- redress, covering complaints, dispute resolution and compensation.

¹⁴ Sections 3 to 6 FSMA 2000.

A.73 Banking as a whole is not a regulated activity under FSMA 2000, but the provision of PCAs is. Under FSMA 2000, before they can do business in the PCA market, banks and building societies must first be authorised by the FSA to accept deposits in the UK in the course of the carrying on a deposit-taking business. As an ongoing condition of obtaining such authorisation, they must demonstrate that they maintain adequate capital liquidity and other matters of banking prudence. They must also demonstrate compliance with all the relevant FSA rules and obligations under FSMA 2000 and other laws applicable to them.

A.74 In order for a firm to carry a regulated activity the FSA must be satisfied that the firm can meet and continue to meet certain minimum standards called 'Threshold Conditions' (set out in the FSA Handbook) and that the persons running the firm are fit and proper. In order to apply for authorisation a firm will need to:

- decide on the type of business it wants to do and the scope of permission it needs to apply for
- be familiar with the Principles for Businesses (in the Handbook)
- prepare a business plan setting out planned activities, budget and resources
- decide which rules in the FSA Handbook apply to the activities the firm wishes to carry on and take all reasonable steps to ensure it is ready willing and organised to comply with those rules
- determine the minimum regulatory financial requirements (found in the Handbook)
- determine the systems and controls required to support the firm's activities and comply with the relevant rules, and have plans to implement and test those systems before the application is due to be determined
- determine which staff should have appropriate qualifications, and

- decide who will fall under the approved persons regime and apply in good time for them to obtain the necessary approval.

- A.75 Once the FSA receives a complete application and the correct fee it will be able to start processing it. This ordinarily involves ongoing dialogue with the applicant to ensure that the FSA is satisfied that the appropriate requirements will be met.
- A.76 If an application is successful the firm will receive written confirmation of its authorisation accompanied by its Scope of Permission Notice – this is the formal 'permission' under Part IV FSMA 2000 (known as 'Part IV permission') and sets out the date when the permission starts and which regulated activities the firm has permission to carry on as well as any requirements or limitations on it.
- A.77 If an application is not successful and the FSA is proposing to refuse an application there is a procedure in place to allow the applicant to challenge the proposed decision. Where, following that procedure, an application is ultimately refused the FSA will issue a final notice confirming the decision and a summary of that notice will be published.
- A.78 Occasionally, a firm is unable fully to meet the requirements at the time of applying for authorisation. For example, a firm may not wish to inject the necessary capital until it is clear that authorisation will be granted. The FSA will consider whether it could advise the applicant that it is 'minded to grant' the application, provided that certain conditions are fulfilled.
- A.79 Once authorisation is granted, the FSA expects a firm to commence regulated activities in accordance with the business plan submitted. When the FSA grants a Part IV permission it will update the public record - the FSA Register – with a general description of the regulated activities the firm has permission to carry on.
- A.80 The FSA can exercise its own-initiative powers¹⁵ to vary or cancel a firm's Part IV permission if it does not commence a regulated activity for which it has

¹⁵ Under section 45 FSMA 2000.

permission within 12 months from the date that the permission was granted or where the firm does not carry on a regulated activity for which it has permission for at least 12 months. If the FSA decides to exercise these powers it will discuss its proposed action with the firm to find out the reasons for not starting or carrying on the regulated activities concerned.

- A.81 An approved person is someone who is approved to perform a controlled function for an authorised firm or an appointed representative firm¹⁶ (a firm with authority to act as an agent for an authorised firm). To become an approved person an individual must apply to the FSA and satisfy them that they can meet (on an ongoing basis) the criteria for approval (the fit and proper test) and perform their controlled function in accordance with the Statements of Principle and Code of Practice for Approved Persons. The fit and proper test is a benchmark used to assess all applicants' suitability to perform controlled functions. The most important criteria considered by the test are the person's honesty, integrity and reputation; their competence and capability; and their financial soundness. Further details of the test are set out in the FSA's Handbook.
- A.82 The controlled functions are those roles within an FSA regulated business that have a particular regulatory significance, for example being a director of a regulated firm is a governing controlled function. No firm will need all of the controlled functions potentially available; different controlled functions will be required depending on the type of business a firm carries on. Changes to the controlled functions have come into effect from 1 November 2007 as a result of changes required by the Markets in Financial Instruments Directive (MiFID).
- A.83 If an approved person does not comply with the regulatory requirements they can be fined or publicly reprimanded. Exceptionally, the FSA may also take action to remove their approved person status.

¹⁶ As defined in full in the FSA's Handbook Glossary.

- A.84 In respect of inward-passporting branches of EEA banks providing PCAs¹⁷ (see further below) the EEA state in which the EEA bank's head office is located will generally be responsible for authorisation and for monitoring compliance with the prudential requirement of the branches. However, where such a branch is situated in the UK, certain FSA rules, in particular those applying to conduct of business and money laundering, will still be applicable.
- A.85 The FSA has powers under FSMA 2000 to write conduct of business rules for deposit taking. However, it has elected not to do so and the current system of voluntary regulation of the conduct of business in relation to deposit taking (including PCAs) under the Banking Code (discussed below) remains in place.
- A.86 Decisions taken by the FSA can be appealed to the Financial Services and Markets Tribunal.¹⁸
- A.87 FSMA 2000 also provides for a single Financial Services Compensation Scheme (where an authorised person or an appointed representative is unable or likely to be unable to meet a claim against them).

The Financial Ombudsman Service

- A.88 FSMA 2000 makes provision for a single ombudsman (known as the Financial Ombudsman Service (FOS)) providing an alternative dispute resolution scheme for customers of FSA-authorized firms. The Act provides for two types of jurisdiction: 'compulsory jurisdiction' and 'voluntary jurisdiction'. Authorised firms (including banks and building societies) must submit to the compulsory jurisdiction (though customers use it voluntarily). For certain types of complaint not subject to the compulsory jurisdiction, businesses may choose

¹⁷ That is, those that are operating under EU legislation which provides for an EEA-wide licence for banks authorised in one member state to set up branches in another member state without having to go through the whole authorisation process again in each branch's member state.

¹⁸ The tribunal is established by section 132 FSMA 2000 and further detail on its constitution and operation can be found in Schedule 13 of FSMA 2000.

to sign up to the voluntary jurisdiction.¹⁹ Customers who are eligible to use the schemes include private individuals, small businesses and some third parties. The powers of the ombudsman to require the disclosure of information are the same under each scheme.

- A.89 Generally speaking the compulsory scheme applies to authorised firms insofar as they undertake regulated activities. The FOS also has (since April 2007) a consumer credit jurisdiction in respect of activities by institutions that are licensed by the OFT under the Consumer Credit Act 1974, as amended, to carry on consumer credit and related business.
- A.90 Under the compulsory and consumer credit jurisdiction the ombudsman has greater freedom than a court of law would have in determining cases before it: since the Act requires the complaint to be 'determined by reference to what [the ombudsman considers is] fair and reasonable'.²⁰ The complainant has the choice whether to accept the ombudsman's finding or not. If he does accept it, it becomes final and binding – and no appeal lies. If he chooses not to accept it he can pursue other routes of redress, including in the courts.
- A.91 In addition, the ombudsman's power to make a money award is not constrained by what would be recoverable in a court. He may award 'such amount as [he] considers fair compensation for loss or damage',²¹ covering both financial loss and other types of loss or damage. There is a maximum limit for monetary awards, but the ombudsman can recommend a further payment that exceeds this if the loss has exceeded the limit. Monetary awards are enforceable as county court orders.
- A.92 The ombudsman can also issue a direction to the respondent to take such action 'as the ombudsman considers just and appropriate',²² not limited to action that could be ordered by a court. There is also provision for the award

¹⁹ These include, for example, complaints about certain banks and general insurance companies based in Europe and not regulated by the FSA; complaints about firms in respect of events that predate the compulsory jurisdiction.

²⁰ s228(2) FSMA 2000.

²¹ s229(2)(a) FSMA 2000.

²² s229(2)(b) FSMA 2000.

of costs. The ombudsman procedure is relatively swift and informal and is inquisitorial rather than adversarial.

The Banking Code

- A.93 The Banking Code is a voluntary code produced by the banking industry with the aim of setting minimum standards for banks and building societies in their dealings with their personal customers (persons 'acting for purposes which are not linked to their trade, business or profession'²³). It applies to most retail products and services, including PCAs. Section 2 of the Code contains a promise to 'act fairly and reasonably' when providing products and services covered in the Code. Section 2 sets out eight 'key commitments'²⁴: to make sure that advertising and promotional literature 'is clear and not misleading' and that customers are given 'clear information about...products and services'; to give 'clear information' (including as to the terms and conditions and interest rates) about accounts or services; to send 'regular statements (where appropriate)' and information about any changes; to help customers 'switch... current account between financial institutions'; to 'lend responsibly'; to 'deal quickly and sympathetically with things that go wrong and consider cases of financial difficulty sympathetically and positively'; to treat personal information as private and confidential and provide secure systems; and to publicize the Code and train staff to put it into practice.
- A.94 The Code contains extensive provision as to interest rates and how changes to them will be made.²⁵ It provides that 30 days notice will be given of any increase in charges or introduction of new charges, and that warnings will be given in advance of charges for cash card use.²⁶ A 14-day cooling-off period is given on the opening of a PCA, and there is a promise of co-operation when customers switch their accounts to another institution.²⁷

²³ Banking Code definition of 'personal customer'.

²⁴ Banking Code, Section 2.

²⁵ Banking Code, Section 4.

²⁶ Banking Code, Section 5.

²⁷ Banking Code, Section 7.

- A.95 There is a section setting out obligations for PCAs regarding statements, the clearing cycle, direct debits and other recurring transactions, cheques, foreign exchange services, protecting accounts, and dormant accounts.²⁸ There is also a section on Cards and PINs.²⁹ There are sections on how banks will approach a customer's financial difficulties,³⁰ how complaints will be handled³¹ and how further help or information can be obtained.³²
- A.96 Compliance with the Code is monitored by the Banking Code Standards Board. The Code says nothing about its legal status and given that it is a voluntary code this could suggest that it has no legal effect at all. However since banks promote the fact that they adhere to the Code and make it available to customers it could be said that its provisions were akin to implied terms in the banking contract. Insofar as the Code seeks to articulate good practice it is taken into account by the FOS in deciding what is a 'fair and reasonable' result – though the FOS may go further than the Code in determining what is fair.
- A.97 The Code has been in operation since 1992, and has been reviewed several times. The third independent review (conducted by Mike Young) was published in November 2007. The review found no major gaps in the Code but recommended changes to reflect developments in the industry and in the regulatory environment, including:
- increased focus by the FSA on 'Treating Customers Fairly' and a move towards more principles based regulation
 - the Consumer Credit Act 2006
 - the Consumer Protection from Unfair Trading Regulations 2007
 - the report of the Competition Commission on personal current accounts in Northern Ireland

²⁸ Banking Code, Section 9.

²⁹ Banking Code, Section 10.

³⁰ Banking Code, Section 14

³¹ Banking Code, Section 15

³² Banking Code, Section 17.

- the agreements reached by the OFT's Payment Systems Task Force.

The 2008 editions of the Banking Code and the Business Banking Code, updated to take on board recommendations from the independent review, came into effect on 31 March 2008.

International regulation

The Basel Committee

- A.98 The UK's national regulatory activities are coordinated internationally through the Basel Committee on Banking Supervision (the Basel Committee), which has representatives from central banks and financial regulators in the 13 major banking countries. The Basel Committee formulates broad standards and guidelines for the convergence of regulatory approaches amongst its members.
- A.99 The Basel Accord of 1988 (Basel 1) set out international standards for capital adequacy. It was translated into EU law through a series of directives. A revised Basel Accord, issued in June 2004 (Basel 2) developed these standards to take account of product innovation which increased the complexity of financial markets.
- A.100 Basel 2 was adopted in the EU in June 2006 by the EC Capital Requirements Directive. It was implemented in the UK in January 2007. The new FSA rules taking it into account came into force on 1 January 2007, but there is a transitional period until 1 January 2008. The overall effect of the changes is expected to be that capital requirements in respect of corporate lending, residential mortgages and retail lending to personal customers will be lower, but more capital will be needed to support specialized and poorer-quality corporate lending.
- A.101 The recent Northern Rock liquidity problems have caused some criticism of the focus of the Basel 1 and Basel 2 standards on capital adequacy alone, without also addressing liquidity. In a speech on 11 April 2008 the Chancellor of the Exchequer called for rapid implementation of the Basel II framework to improve the prudential regulation of banks and support better risk management, supported by international action on management of liquidity risk through the Basel Committee, and action by credit ratings agencies to strengthen the

quality and integrity of the ratings process and to enhance the information content of ratings.

The EU

A.102 The EU has adopted a number of directives to harmonise regulation of the banking industry, including those that incorporated Basel 1 and Basel 2. The main principles underlying the movement towards an EU single market in banking are:

- harmonisation of member states' laws and practices governing access to the market, capital requirements, limitations on large exposures to particular borrowers or groups of associated borrowers, and accounting rules and standards
- home-country control of banking groups, with cooperation between national supervisory authorities to enable a bank operating in other member states to be licensed and supervised by the authority in the country in which it has its registered office (the 'single European passport')
- mutual recognition by the national supervisory authorities of the rules and regulations in the countries of origin of the EEA banks operating in their territory.

A.103 The 1989 Second Banking Coordination Directive,³³ which provided for the 'single European passport' was implemented in the UK on 1 January 1993 by the Banking Co-ordination (Second Council Directive) Regulations 1992.³⁴ The 2000 Banking Consolidation Directive³⁵ replaced the earlier directive and brought together a series of other banking directives including the Capital Adequacy Directive. It did not, however, substantially alter the law.

³³ Directive 89/646/EEC.

³⁴ S.I. 1992, No. 3218.

³⁵ Directive 2000/12/EC.

- A.104 Under the single passport system, authorisation in the home state confers a passport on the bank to operate throughout the EEA without the need for further authorisations. In fact, banks are obliged to obtain their authorisation in their home state and cannot obtain it elsewhere. The taking of deposits is one of a list of activities that can be 'passported' in this way.
- A.105 A bank may operate in another EEA state either by establishing a branch or by providing cross-border services but before doing so it must notify its home regulator which must in turn notify the host state regulator. FSMA 2000 gives effect to these principles and provides that banks from other EEA states can carry on passported activities in the UK without the need for FSA authorisation. As noted above, the FSA retains a limited supervisory role in relation to such banks. Similarly a UK bank, once it is authorised under FSMA 2000, acquires a passport entitling it to provide banking services in other EEA states, provided that it notifies the FSA first.
- A.106 Further harmonisation has taken place under the framework of the 1999 EU Financial Services Action Plan, which listed 42 measures, including the Second Money Laundering Directive and the Electronic Money Directive, that needed to be adopted in order to complete the single market in wholesale financial services by 2005, make retail markets open and secure, and strengthen the rules on prudential supervision. Most of the legislative instruments in this framework are now in place.
- A.107 In addition, the EU has adopted rules on money laundering, deposit-guarantee schemes and monitoring of market risk. The Third Money Laundering Directive was adopted in October 2005 and implemented in the UK by means of the Money Laundering Regulations 2007,³⁶ which took effect from 15 December 2007. It updates EU legislation to take into account international recommendations on money laundering and counter terrorist financing measures.

³⁶ SI 2007/2157.

What additional existing and future legal protections are there for PCA customers?

- A.108 There are various other statutory provisions which add legal protections for PCA customers, or which will do so in the future.

The Data Protection Act 1998

- A.109 The Data Protection Act 1998 (DPA 1998) gave effect to European Council Directive 95/46 on the protection of individuals with regard to the processing of personal data and the free movement of such data.³⁷ The processing of personal data must comply with the eight data protection principles (set out in Part 1 of Schedule 1 to the Act). These include the principles that personal data must: be used fairly and lawfully; be obtained for specified purposes and used only in ways compatible with these purposes; be adequate, relevant, and not excessive in relation to the purpose for which the data are processed; be accurate, and, where necessary kept up to date; and that appropriate measures are taken against unauthorised or unlawful use of data and their accidental loss or damage.
- A.110 Individuals are given rights under the Act which includes the right of access to personal data. The Banking Code states at paragraph 11.3: 'We will explain to you that under the Data Protection Act you have the right to see the personal records we hold about you.'

The Human Rights Act 1998

- A.111 The Human Rights Act 1998 (HRA 1998) incorporates the European Convention for the Protection of Human Rights and Fundamental Freedoms into domestic law by three means. Firstly it requires the courts to construe all legislation so far as it is possible in a way which is compatible with Convention rights. Secondly it is unlawful for a public authority to act in a way which is incompatible with a Convention right. Thirdly, the HRA 1998 sets out a procedure whereby the courts can issue a declaration of incompatibility in

³⁷ [1995] OJ L281/31.

respect of legislation which is incompatible with a Convention right, with Parliament deciding whether it should amend the legislation.

A.112 The HRA 1998 does not give private citizens a right of action against each other based on a breach of Convention rights, but it is likely that the HRA 1998 will indirectly affect the way in which courts and tribunals deal with proceedings between private individuals. For example the right to respect for an individual's private life, guaranteed by Article 8 of the Convention will influence the development of the law protecting confidences.

The Unfair Terms in Consumer Contracts Regulations

A.113 The Unfair Terms in Consumer Contracts Regulations 1999³⁸ (UTCCRs) give the FSA and the OFT powers to challenge firms that are using unfair terms in contracts with consumers. A concordat agreed between the OFT and the FSA sets out that the OFT will consider any issues of fairness of terms arising under the UTCCRs in relation to standard terms in financial services contracts for activities that are governed by the Consumer Credit Act 1974 as amended, including overdrafts.

A.114 The OFT is currently investigating the fairness of personal current account unauthorised overdraft charges and returned item charges under the UTCCRs. As part of this investigation it pursued a test case in the High Court for a declaration on the application of the UTCCRs to unauthorised overdraft charges and returned item fees on personal current accounts. The other parties in the test case were eight banks³⁹ that together account for around 90% of personal current accounts in the UK. The court ruled, on 24 April 2008, that personal current account unarranged overdraft charges can be assessed for fairness under the UTCCRs. On 23 May, the banks were given leave to appeal this finding. The OFT is continuing with its investigation into the fairness of the relevant terms in the banks' current terms and conditions.

³⁸ SI1999/2083

³⁹ The banks involved are Abbey National plc, Barclays Bank plc, Clydesdale Bank plc, HBOS plc, HSBC Bank plc, Lloyds TSB Bank plc, Royal Bank of Scotland Group plc, and Nationwide Building Society.

The Unfair Commercial Practices Directive

- A.115 The Unfair Commercial Practices Directive (UCPD)⁴⁰ has been implemented into UK law by the Consumer Protection from Unfair Trading Regulations⁴¹ (CPRs) which came into force on 26 May 2008. The CPRs ban businesses in all sectors from using unfair commercial practices towards consumers.
- A.116 The UCPD aims to harmonise the legislation on unfair business to consumer practices across the European Community. It will give consumers greater confidence to shop in the UK and across borders by providing a high common standard of consumer protection.
- A.117 Given the UCPD's broad scope some pieces of UK legislation, such as the Trade Descriptions Act 1968 and the Consumer Protection Act 1987, have been repealed or amended.

In summary the UCPD

- creates a high common level of consumer protection
 - applies a consistent law across the European Union
 - fits with the Regulation on Consumer Protection Cooperation.⁴²
- A.118 The CPRs apply to actions, omissions and other conduct by businesses directly connected to the promotion, sale or supply of products to or from consumers (whether before, during or after a transaction).
- A.119 Regulation 3 contains a general prohibition of unfair commercial practices. A commercial practice is unfair if:
- it is not professionally diligent, and

⁴⁰ Directive 2005/29/EC

⁴¹ Draft Regulations in BERR consultation: www.berr.gov.uk/files/file39705.pdf

⁴² Regulation (EC) No 2006/2004

- it materially distorts or is likely to materially distort, the economic behaviour of the average consumer.

- A.120 Essentially, for a practice to be prohibited under these provisions the conduct of the practice must be of an unacceptable standard as well as there being an effect (or the likelihood of such) on the economic behaviour of the average consumer.
- A.121 Regulations 5-7 of the CPRs prohibit commercial practices which are misleading (whether by act or omission) or aggressive and which cause or are likely to cause the average consumer to take a different transactional decision.
- A.122 The Regulations contain a list of 31 practices which are also prohibited in all circumstances.

Possible impact of the Consumer Protection from Unfair Trading Regulations (CPRs) on the Banking sector

- A.123 The CPRs cover unfair business to consumer practices relating to all products and services, including all the services provided to consumers by banks and other financial institutions, and their agents. Once implemented, it will be necessary for all banks to ensure that they do not engage in unfair commercial practices as defined in the CPRs. This is in addition to current requirements in the Consumer Credit Act 1974 (as amended), the Financial Services and Markets Act 2000, the Unfair Terms in Consumer Contracts Regulations 1999 and other relevant legislation.

Regulation 4 – Codes of conduct

- A.124 This enables enforcers to take civil injunctive action where a code of conduct promotes unfair commercial practices. Were banking sector codes to promote practices prohibited by the Regulations, the Office of Fair Trading, the Financial Services Authority or other Part 8 Enterprise Act enforcers, in line with their enforcement policies, would engage in consultation with the relevant bodies to secure necessary changes. Were that to fail, formal court action would have to be considered.

Regulation 5 – Misleading actions

- A.125 This prohibition is similar to that contained in the Control of Misleading Advertising Regulations 1988 (as amended) which will be replaced by the CPRs. If statements, either in printed advertisements or other media including verbal representations mislead consumers, then action may be taken.
- A.126 A failure to comply with a firm and verifiable commitment in a code of practice to which a trader has undertaken to be bound is prohibited as a misleading commercial practice if the trader indicates in the commercial practice (e.g. by using a logo) that it is bound by the code.

Regulation 6 – Misleading omissions

- A.127 The extent to which this prohibition, which has been seen by some legal commentators as an 'indirect duty' to disclose material information, will affect banking is as yet unclear. It could mean that banks are obliged to make sure that any charges or changes to existing accounts and the limited nature of any introductory offers are made clear to consumers. It might also require agents charging commission to make this clear to consumers. The prohibition requires that consumers are given material information clearly, and in a timely fashion, and that any such information is not hidden.

Regulation 7 – Aggressive commercial practices

- A.128 This covers undue influence (which is concerned with an abuse of a position of power), coercion and harassment. It is likely to cover aggressive practices towards debtors. It may also cover situations where banks coerce consumers into changing accounts or closing their accounts in an unfair fashion.

Schedule 1 Practices

- A.129 There are 31 practices prohibited in all circumstances. All traders should familiarise themselves with these specific prohibitions and ensure that they do not engage in such practices, which include, for example, false claims of code membership, false claims of product availability, direct exhortations to children and false claims relating to a product being 'free'.

The Consumer Credit Acts 1974 and 2006

A.130 The Consumer Credit Act 1974 (CCA 1974) regulates:

- consumer credit agreements and consumer hire agreements (collectively known as regulated agreements), for example a bank overdraft (even if it is extended by the bank without a prior arrangement with the customer)
- various ancillary consumer credit and consumer hire agreements – which are capable of constituting regulated agreements in certain circumstances and include guarantees, indemnities and linked transactions
- the general conduct of consumer credit business including ancillary credit business such as credit brokerage, covering licensing requirements, advertising controls, restrictions on canvassing and other methods of seeking business and rules affecting some of the operations of credit reference agencies and (when the CCA 2006 is fully in force⁴³) those who supply debt administration and credit information services, and
- the administration and enforcement of the Act and penalties for breach.

A.131 In the context of PCAs CCA 1974 is relevant to the provision of overdrafts: a bank overdraft extended to an individual falls within the definition of a regulated consumer credit agreement for unrestricted-use running account credit.⁴⁴ It is also relevant to the provision of credit cards, which are not the main focus of this study. Additionally any bank that provides consumer credit – including by way of overdraft facilities must first obtain a consumer credit licence from the OFT. These points are considered further below.

⁴³ The BERR timetable for implementation (at <http://www.berr.gov.uk/consumers/consumer-finance/credit-act-2006/Timetable/page29768.html>) outlines implementation dates ranging between June 2006 and October 2008.

⁴⁴ s10(1) & 11(2) CCA 1974.

A.132 CCA 1974 has been amended by the Consumer Credit Act 2006 (CCA 2006), which received Royal Assent on 30 March 2006 and is the first major overhaul of the primary legislation since the CCA 1974 was passed.

A.133 The principal areas of change to the CCA 1974 introduced by the CCA 2006 are:

- change to the basic structures of credit regulation
- new provisions for statements to be given to debtors under regulated fixed credit agreements
- strengthening the rules on dealing with default including the obligation to send information sheets with notices
- replacing the rules relating to 'extortionate credit bargains' with the new concept of 'unfair relationships' between creditors and debtors
- reform of the consumer credit licensing system and creation of the Consumer Credit Appeal Tribunal
- bringing consumer credit within the ambit of the Financial Ombudsman scheme
- miscellaneous and consequential provisions.

A.134 The provisions of CCA 2006 relating to 'unfair relationships' for new agreements (there is a transitional period, until 6 April 2008 before the unfair relationships test applies to existing agreements) and the new consumer credit jurisdiction extending FOS' existing mandate came into force in April 2007. In April 2008 the provisions relating to the reform of the credit licensing regime and the enhancement of OFT powers came into force. Provisions on transparency are expected to come into force on 1 October 2008.

A.135 The Financial Ombudsman notes (in its 'quick guide to our role in settling consumer-credit disputes') that it 'already had considerable knowledge and experience in this area as we had always dealt with complaints about the

consumer-credit activities of businesses such as banks, building societies and credit unions authorised by the FSA'.

A.136 In April 2008 the test of fitness applied to applicants for a consumer credit licence and licensees was broadened to give the OFT power to assess the competence of a business to provide credit services, looking ahead to likely future behaviour as well as checking past misconduct. The test also explicitly includes a reference to 'irresponsible lending' as an unfair or improper practice that the OFT can take into account when assessing or reviewing fitness.

A.137 The new 'unfair relationship' test relates to whether or not the relationship between a lender and borrower is unfair to the borrower because any of the following:

- the terms of the credit agreement or any related agreement, or
- the way that the lender has used or enforced his rights under the agreement, or
- any other thing done, or not done, by or on behalf of the lender either before or after the agreement was made.

A.138 The test will be applied by the court which has wide remedies to deal with such agreements. However the OFT will also have powers to take action under Part 8 of the Enterprise 2002, where unfair relationships harm the collective interests of consumers.

A.139 The consumer credit licensing system affects banks in two ways. If they wish to enter into consumer credit business or engage in ancillary credit business they will need to have a consumer credit licence. A bank also has to be wary where it finances another financial institution engaging in regulated transactions or carrying on ancillary credit business since, if that institution is not licensed any loan agreements may be unenforceable – which may affect the bank's ability to obtain repayment from the other financial institution of advances made.

A.140 CCA 1974 also sets out formalities which have to be complied with when a regulated agreement is executed – essentially full disclosure of the terms of

the contract is required. However, although overdrafts fall within the scope of CCA 1974, they are exempt from the provisions of Part V of the Act relating to the entering of a credit agreement and its form and content and cancellation, as a result of a Determination made under section 74(3) CCA 1974 by the then Director General of Fair Trading in 1989 (replacing an earlier Determination).⁴⁵

- A.141 Regulations made under the CCA 1974 contain a formula for calculating the total cost of credit and an annual percentage rate (APR) – which seeks to show the true cost of the credit incurred by the consumer. With some banking transactions, for example an overdraft or credit card agreement, the actual cost of credit will depend on how the facility is used. The Regulations contain assumptions to be used when calculating the APR.
- A.142 CCA 1974 controls the content of certain credit advertisements which indicate that an institution is prepared to provide credit – where the financial institution conducts a consumer credit business or lending by mortgage to individuals. To issue a false or misleading advertisement is an offence. Regulations made under the CCA 1974 contain the detail of what is to be included in an advertisement. These regulations generally require disclosure, in a prescribed manner, of the true cost of credit. The disclosure provisions do not generally apply to overdrafts (by virtue of their being excluded from Part V CCA 1974).
- A.143 Generally then, the statutory requirements about pre-contract disclosure, and those dealing with the form and content of credit agreements do apply to overdrafts. It is worth adding that the Banking Code requires banks to provide information on interest rates and charges to customers.
- A.144 The canvassing of 'debtor-creditor' agreements such as personal loans is prohibited by section 49 CCA 1974. 'Canvassing' is defined to mean visiting a debtor without invitation so as to persuade them to enter into an agreement. However there is an exemption (in s49(3)) for the canvassing of entry into overdraft agreements on a current account, where two conditions are satisfied. Firstly, the account must be covered by a Determination of the (then) Director General of Fair Trading. Current accounts operable by cheques or

⁴⁵ Determination made on 21 December 1989 (replacing that of 3 November 1983).

similar orders have been the subject of such a Determination.⁴⁶ Secondly, the person canvassed must be the holder of the account.

- A.145 CCA 1974 maintains a bank's right to demand repayment of an overdraft without notice. Generally seven days notice is required from a creditor before he can enforce his agreement. Given that overdrafts are repayable on demand, notice would not usually be needed unless the overdraft had been extended for a specific period and was called up within that time.
- A.146 CCA 1974 and regulations made under it require a bank to give a customer at his request, information on the state of his account and to send him periodic statements. Similarly the Banking Code requires banks to provide customers with 'regular account statements' unless this is not appropriate for the type of account held, such as an account with a passbook.

⁴⁶ Determination of 1 June 1977.