Statement by former Members of the Parliamentary Commission on Banking Standards

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Tuesday 4 November 2014

Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards was appointed by both Houses of Parliament to consider and report on professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process, lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy and to make recommendations for legislative and other action. The Commission published its final report, *Changing banking for good*, in June 2013.

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Publications

The Reports and evidence of the Commission are published by The Stationery Office by Order of the House. All publications of the Commission (including press notices) are on the Internet at http://www.parliament.uk/bankingstandards.

Published reports of the Parliamentary Commission on Banking Standards

First Report, HL 98/HC 848
Banking reform: towards the right structure, HL 126/HC 1012
Proprietary trading, HL 138/HC 1034
'An accident waiting to happen': The failure of HBOS, HL 144/HC 705
Changing banking for good, HL 27/HC 175

Introduction

1. It is well over a year since the Parliamentary Commission on Banking Standards published its final Report. During that time further examples of grave misconduct have come to light, incurring substantial fines and reinforcing the need for radical reform. The Commission was established in July 2012 to consider professional standards and culture in the UK banking sector. This followed a series of taxpayer bailouts, a string of mis-selling incidents, and the LIBOR scandal. These had made the banking industry appear not only irresponsible and incompetent, but morally bankrupt. The Commission was charged with recommending legislative and other changes necessary to address the low standards present in the UK banking sector.

2. The low standards in banking resulted from deep-seated problems across a range of areas within the industry:

- Banks had become too big, too important and too complex to be allowed to fail. This led to an implicit taxpayer guarantee, providing banks with incentives to take excessive risk.
- Competition, especially in retail banking, was weak, reducing banks' incentives to address failings in standards.
- Individual incentives were misaligned. There was insufficient individual accountability at senior levels, and remuneration structures led to a fundamental misalignment of risk and reward.
- Regulation was misconceived and poorly targeted, and too narrowly rules-based rather than judgement-based.

3. There was, and is, no silver bullet. Rather, the Commission proposed realistic and achievable reforms on a number of fronts, building on the proposals of the Independent Commission on Banking (ICB), aimed at restoring trust and health to the banking sector. These needed to be implemented together to have the best chance of transforming standards and culture in banking.

4. Initial responses from the Government and the regulators to the Commission's proposals were generally welcoming, although concrete action was, at first, less forthcoming. In the months following publication, former Commissioners successfully pressed the Government to implement some of the Commission's most significant reforms in the Financial Services (Banking Reform) Act 2013, and secured more specific assurances from the regulators on the non-statutory elements of reform.

5. Following Royal Assent, detailed implementation of our proposals fell to secondary legislation, the regulators, and banks themselves. The Government has now proposed secondary legislation further defining the ring fence, and the regulators have published consultations—on which we provide views in this document—on three major areas of the Commission's work: ring-fencing, the regulatory regime for individuals, and remuneration. Being still in the stages of detailed design, however, none of our reforms have yet been implemented by banks. The numerous and varied problems in banking that

we identified remain, therefore, unaddressed. It is essential that the momentum behind our reforms is maintained. There is much still to do.

Ring-fencing, resolution and proprietary trading

Ring-fencing

6. The Government asked the Commission at its inception to conduct pre-legislative scrutiny of the Financial Services (Banking Reform) Bill, which would implement the proposals of the ICB. This reflected a recognition that structural changes to UK banks could serve as part of the way forward in relation to banking standards and culture.

7. Among the ICB's chief recommendations was that banks should be required to 'ring fence' certain retail banking activities—those where continuous provision of service is vital to the economy and to the bank's customers—from other, potentially riskier activities. This would help to ensure that the provision of these critical services would not be threatened as a result of activities which were incidental to it. The ring fence would also be part of a package designed to make it easier to 'resolve' the retail arm of a bank—to close it down while preserving continuity of provision of its vital activities, without the need for taxpayer support. The ring fence would also force banks to capitalise properly the non-ring-fenced elements of their business, without the need for—or the option of—recourse to their retail arms.

8. The Commission reviewed the legislative proposals, and concluded that additional powers to 'electrify' the ring fence were needed. Such powers would be vital to protect the integrity of the ring fence, and to reduce the risk of ring-fencing failing to meet its objectives. The Commission recommended two distinct powers:

- a 'first reserve power', which would allow the regulator to require an individual bank to divest itself either of its ring-fenced or of its non-ring-fenced elements, if that bank were seen to be gaming the ring-fencing rules. The Government accepted and eventually implemented this proposal in legislation, albeit after initially proposing clauses which fell well short of what was required.

- a 'second reserve power', under which full separation of ring-fenced from non-ring fenced banks would be required across the whole industry. This power would be exercisable only after a full, independent review of whether the ring-fence was meeting the objectives set out in legislation. The Government refused to legislate for a second reserve power that could be activated upon completion of the independent review. But, during the passage of the Bill, the Government eventually agreed to an independent review of the operation of the ring-fencing legislation, which would be conducted within two years of the regime coming into force. The Government confirmed that this review would be able to recommend full separation across the industry, if it considered that ring-fencing was not meeting its objectives.

9. Almost a year has now passed since the Financial Services (Banking Reform) Act 2013 received Royal Assent. Work to implement ring-fencing is still at a very early stage. Under current plans, the regime will not come into force until 2019, and no commencement date

has yet been set for the ring-fencing provisions in the Act to be formally activated. However, some important steps towards implementation have been taken:

- The Government has consulted on, and laid before Parliament, secondary legislation. Among other things, this refined the definition of a ring-fenced bank and the activities such banks can perform. As reported by the Treasury Committee, the proposals accorded in a number of respects with the conclusions of the Commission.

- The PRA has proposed regulatory requirements on the structure of those banking groups containing ring-fenced banks, and their governance arrangements. It expects banking groups to adopt a sibling structure in which ring-fenced banks cannot be owned by a non-ring fenced bank, and must instead sit as a subsidiary to a parent holding company. In its first report, the Commission recommended such a requirement as a means of strengthening the ring fence—as the ICB pointed out, allowing a non-ring fenced bank to own a ring-fenced bank would permit a parent-subsidiary relation based on control, which would contradict the principle of independence. The PRA's governance proposals also enforce the operational independence of a ring-fenced bank from other entities in its banking group in respect of, for example, risk management and HR. Again, the Commission said that this was essential for the maintaining the independence of ring-fenced banks.

10. Regulators have yet to develop and consult on the rules that will describe other detailed workings of the ring-fence. In particular, the PRA has yet to make proposals on the limits that will be placed on financial exposures between ring-fenced banks and other members of their banking group. This will be crucial to shielding ring-fenced banks and the core activities they perform from the risks to which non-ring fenced banks can expose themselves. The PRA has also yet to consult on how it will implement electrification. Other important practical considerations will also have to be addressed before ring-fencing comes into effect, including how corporate governance and consolidation of financial statements will function when a banking group is divided into independent, ring-fenced and non-ring-fenced entities.

11. **The Government's initial legislative proposals to give effect to electrification, put forward a year ago, were inadequate. Without the threat, recommended by the PCBS, of having their banking group split up—so-called 'electrification'—banks would have had unfettered incentives to game the ring-fence, endangering every benefit of the reforms. We are particularly grateful to the former Commissioners in the Lords for their efforts to put this right. In response to their arguments, the Government amended the Bill, ensuring that electrification can be a credible deterrent. This was a vital development. In the absence of electrification, it is likely that banks would have been tempted to game the ring-fence. Even now a risk remains. It is the job of regulators to ensure that banks appreciate the consequences of attempting to game the ring-fence: separation. Our support for this measure remains undimmed, as does our support for the regulator in implementing it.**

12. **Former Commissioners also secured a statutory requirement for an independent review of ring-fencing within two years of the regime coming into force. This will be able to consider whether other regimes—for example, full legal separation of ring-**

fenced from non-ring fenced banks across the industry, as opposed to separation within a banking group—would better meet the ring-fencing objectives. This review is vital for two reasons: first, as an untested experimental reform, it is essential that ring-fencing be reviewed within a suitable timeframe to ensure that it is meeting its objectives; and second, as the review will be able to consider full separation, it will provide banks with a further incentive not to game the ring-fence.

13. **Now that primary legislation has put the framework for ring-fencing on the statute book, it falls to secondary legislation and regulation to implement it in practice. The Government proposed secondary legislation in July 2014, further defining the scope of ring-fencing and the restrictions on ring-fenced banks' businesses; and the PRA published a consultation on the structure and governance of ring-fenced banks in October. The proposals so far accord with the Commission's recommendations in its first and second reports, and are welcome. The PRA is to consult on further matters—including the restrictions on financial transactions between ring-fenced banks and other group members—in due course. These will be particularly crucial, since they will determine how effectively ring-fenced banks can be insulated from the risks of investment banking.**

14. **The tension between the independence of the ring-fenced bank and its accountability and transparency to group shareholders could present serious challenges in respect of corporate governance and financial reporting. The PRA and the Financial Reporting Council should provide an assessment of these challenges, and bring forward proposals on how they might be overcome.**

Resolution

15. The ring fence will assist resolution. But it will not remove the need for it. Without a functioning resolution regime, ring-fencing might simply result in one too-big-to-fail bank becoming two such banks.

16. Banks have substantially increased their levels of capital over the past year, variously through retention of earnings, asset sales and approaches to the market. This welcome progress on core capital will help to reduce the risk of systemic firm failure, and make it less likely that resolution will be needed. But it cannot eliminate the possibility of failure. Events have shown that even banks which appear to have ample capital may be close to failure.

17. Amendments to the Financial Services (Banking Reform) Bill in late 2013 revised the UK's resolution framework, empowering the Bank of England to require a 'bail-in' of a bank's creditors in the event that a bank proves to have inadequate capital resources—a measure that the Commission recommended in its first Report be included in the legislation. Similar EU-wide proposals are set to come into force under the Recovery and Resolution Directive early next year. These reforms enhance banks' capacity to absorb losses without defaulting on deposits and without requiring public support. But they do not remove the vast difficulties of attempting to resolve large, complex, cross-border banks.

18. Recent comments from the Governor of the Bank of England suggest that significant progress can be expected at the G20 in Brisbane later this month. Agreement is expected on several major issues which have held back the resolution of banks too big to fail,

including an approved standard on the 'total loss absorbing capacity' that globally systemic banks must hold, and an agreement by several significant dealer banks—which represent 90% of derivative activity—to stay cross-border derivative contracts temporarily when a global bank fails.

19. But several operational impediments to resolution will remain. International co-operation is also required to ensure that large, complex, cross-border firms can be resolved. The Recovery and Resolution Directive has now been agreed in the EU. And the Bank of England and the US Federal Deposit Insurance Corporation have an agreement about resolving financial institutions across the Atlantic. But neither of these has yet been tested in practice.

20. **Resolution measures, alongside ring-fencing reforms, are crucial to removing the implicit taxpayer subsidy that has been enjoyed by major banks and has led to severe lapses in standards. But a working resolution regime remains a goal rather than a reality. Some legislative progress has been made since the Commission's final Report, and the forthcoming G20 summit in Brisbane is expected to be a 'watershed' moment in efforts to end 'too-big-to-fail'. However, the legislative advances may be insufficient in isolation, and even if agreement is reached on outstanding issues at the Brisbane G20 summit, implementation of any enhanced resolution regime will remain reliant on the co-operation of national regulators at a moment of crisis. Moreover, the effectiveness of any reforms will be difficult to judge until they are tested in practice; that is, until a large cross-border firm fails.**

21. **For as long as there is uncertainty over the efficacy of the resolution regime, the integrity of the ring-fence assumes particular importance: if resolution cannot be relied upon to ensure continuity in the core services of a failing bank, then those services must be insulated from the non-crucial activities that could threaten them.**

22. **Banks must provide their full co-operation to the regulators in drawing up resolution plans. It is also important that banks contribute in any way necessary to the broader work on resolution: banks have a duty to their depositors, and to the wider public, to assist with efforts to ensure that they can be wound down safely.**

Proprietary trading

23. In its third report, the Commission examined the risks arising from proprietary trading. Such trading poses prudential risks which, while similar in nature to those associated with other banking activities, are unnecessary for client servicing. Proprietary trading can also introduce a conflict of interest between a bank and its customers and—with its potential to generate high short-term rewards for individual traders—could have a damaging effect on remuneration expectations and culture throughout the rest of the firm.

24. In the course of our evidence sessions in 2012 and 2013, the main UK-headquartered banks told us that they were not engaging in proprietary trading, and did not wish to do so. We recommended, however, that the PRA verify these claims and, if indications of proprietary trading were found, bear down on such activity.

25. We also recommended that legislation should require, within three years of the Act being passed, a report by the regulators on proprietary trading, including an assessment of

its extent and the case for an outright ban on such activity. This report would form the basis for a full and independent inquiry on the case for action on proprietary trading.

26. During the passage of the Act, following pressure from former Commissioners, the Government agreed to legislate to require both reviews, with slightly amended timetables: the PRA review will commence within a year of ring-fencing coming into force, and the independent review which it informs will commence within two years. **We welcome the legislative support that the Government has given to these crucial reviews.**

New regulatory regimes for individuals

27. The Commission concluded that too many bankers, especially at the most senior levels, had operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures for which they should bear responsibility.

28. To help address the lack of sufficient individual accountability, the Commission recommended an overhaul of the regulatory framework for individuals. The existing framework—the 'Approved Persons' regime, under which certain individuals within banks must seek regulatory approval before taking up their positions—was, the Commission concluded, a complex and confused mess. It failed to perform any of its varied roles to the necessary standard: it was the mechanism through which individuals could notionally be sanctioned for poor behaviour, but its coverage was woefully narrow and it did not ensure that individual responsibilities were adequately defined, restricting regulators' ability to take enforcement action; and it operated mostly as an initial gateway to taking up a post, rather than serving as a system through which the regulators could ensure the continuing exercise of individual responsibility at the most senior levels within banks. The Commission recommended that the Approved Persons regime for banks therefore be scrapped, and replaced with a new framework for individuals.

29. There were two main elements to the Commission's proposed new framework. First, a 'Senior Persons Regime', to be administered by the regulators, would cover those individuals who really run banks and who should stand or fall by their role in decision-making. This regime would make clear where senior individual responsibility lay for each aspect of a firm, encouraging greater clarity of responsibilities and establishing beyond doubt individual responsibility in order to provide a sound basis for the regulators to take action where serious problems occur. Second, a new 'Licensing Regime', to be administered by the banks, would cover all staff who could cause serious harm to a bank, its reputation or its customers. Staff within this regime would have to behave in a manner compliant with new 'Banking Standards Rules' set out by the regulators, and the banks would need to be continually vigilant in ensuring this. The application of the Licensing Regime to a broader range of staff than the Senior Persons or Approved Persons Regimes reflected the need for a wider sense of responsibility and aspiration to high standards throughout the banking sector. Licensed individuals would need to be informed clearly of their duties, since, while they would not be Senior Persons, they could nevertheless have important responsibilities which could have a significant impact on the bank or its customers.

30. The Commission also recommended tough new sanctions on very senior individuals in banks. Faced with the most widespread and damaging failure of the banking industry in the UK's history, the regulatory authorities had seemed almost powerless to bring sanctions against those who presided over massive failures within banks. Yet credible sanctions were essential—not to satisfy a public demand for retribution, but to correct the

unbalanced incentives that pervade banking. The Commission made two specific proposals:

- A new criminal offence of reckless misconduct in the management of a bank—The Commission concluded that, if recklessness in carrying out professional responsibilities were to carry a risk of a criminal conviction, it would give pause for thought to the senior officers of UK banks. By definition, the offence would be limited to individuals involved in the management of a bank. The Commission further proposed that it would be limited to individuals covered by the new Senior Persons Regime. The offence would be pursued in cases involving only the most serious of failings, such as where a bank failed with substantial costs to the taxpayer, lasting consequences for the financial system, or serious harm to customers. The Financial Services (Banking Reform) Act 2013 makes explicit that the offence will apply only in cases where a bank fails.

- Reversal of burden of proof in civil misconduct cases—Faced with the most widespread and damaging failure of the banking industry in the UK's modern history, the regulatory authorities had seemed almost powerless to bring sanctions against those who presided over massive failures within banks. As part of the measures to combat this, the Commission recommended that the regulators should be able to impose civil sanctions on an individual unless that person can demonstrate that he or she took all reasonable steps to prevent or mitigate the effects of a regulatory breach in his or her area of responsibility. This would apply only to individuals in the Senior Persons Regime; and, by definition, it would apply only to individuals with responsibility for particular activities or business areas that could give rise to a regulatory breach.

31. It is important to reiterate that these two sanctions were—and are, as legislated—entirely distinct. They do not interact. The burden of proof would be reversed only in cases of civil misconduct; the burden of proof for the criminal sanction would remain unchanged.

32. The Government welcomed the Commission's proposals. It brought forward draft legislation to implement the Senior Persons Regime, the criminal sanction and the reversal of the burden of proof. It took until Third Reading of the Act in the House of Lords, following pressure from former Commissioners, for the Government to produce clauses to implement Licensing. Legislation in respect of all of the proposals was, however, ultimately passed.

The scope of the SMR, the criminal sanction, and the reversal of the burden of proof

33. While the Government ostensibly accepted the Commission's proposals, in some respects it implemented them in a way which deviated from the Commission's intentions. In some instances the differences were small: 'Licensing' became 'Certification', but the detailed attributes of the regime remained largely intact. In others, however, the differences were material.

34. The Senior Persons Regime was implemented as the 'Senior Managers Regime'. While this change was in itself superficial, the legislation also made the scope of the new regime

coterminous with the scope of the criminal sanction. The Commission, on the other hand, had proposed that the criminal sanction should apply only to the subset of those in the new regime who were responsible for actually managing the bank.

35. The full significance of the legislation became clear only once the detailed implementation of the regimes was considered. In July 2014, the PRA and the FCA published their proposals for implementing the new regimes. These included recommendations for the scope of the SMR. The PRA proposed that the SMR should apply to a handful of the most senior executives and non-executives, including the chief executive, the chairman, the chief risk and finance officers, and the chairs of the audit, risk and remuneration committees. The FCA, however, proposed that the SMR should apply to all executive and non-executive members of a bank's board. The Commission itself had initially proposed that all board and executive committee members should fall within scope of the Senior Persons Regime. However, coupled with the legislation—which made the scope of the Senior Managers Regime coterminous with the scope of the criminal sanction—the FCA's proposals would bring more individuals into the scope of the criminal sanction than the Commission intended.

36. In a similar way, the Commission's proposal on the reversal of the burden of proof was constructed in such a way that, in practice, only those Senior Managers with particular responsibilities for specific activities or business areas—aspects of a firm which could give rise to regulatory breaches under the oversight of an individual—would be subject to it. While a non-executive board member may have a responsibility to be open with the regulator, this is not the type of responsibility that the Commission expected would give rise to a civil misconduct investigation in which the burden of proof was reversed. But in theory, the legislation could allow this. The Act may prove to be in accordance with the Commission's thinking in practice, depending on how the regulators exercise their new powers; but this is not a certainty.

37. **We welcome the support of the Government and the regulators for the Senior Managers Regime, and their efforts in implementing it in practice. However, the Commission's intentions in some cases have been misunderstood or mistransposed in ways which are likely to have unintended consequences. In particular, the criminal sanction for the reckless mismanagement of a bank was intended to apply only to those actually managing a bank. However, the legislation applies the criminal sanction to all members of the Senior Managers Regime, including—given the scope of the SMR proposed by the FCA—all non-executive directors. This was not our intention; the Commission envisaged a scope for the criminal sanction similar to the scope proposed by the PRA for the SMR, as set out in paragraph 35 above. The legislation could also, in theory, open up all Senior Managers—even those without particular responsibilities for specific activities or business areas—up to the reversal of the burden of proof in civil misconduct cases.**

38. **Regulators need to remedy these problems. The most appropriate route would be to narrow markedly the coverage of the SMR proposed by the FCA. Instead of being included by default, board members should only fall within scope of the SMR if they hold specific responsibilities—for example, chair of the audit or remuneration committees—for specific areas or activities of the firm, for which sanction in the event of failure would be appropriate. Those board members who fall outside this category**

should instead be covered by the Certification Regime. This would carry the benefit of still requiring monitoring, and ensuring clarity of responsibility, which were the Commission's aims in recommending the inclusion of all board members. But it would ensure that these individuals were taken out of the scope of the criminal sanction, and the reversal of the burden of proof in civil misconduct cases.

39. **It would have been preferable for the two regulators to have proposed the same scope for the Senior Managers Regime, but they have not. There is an onus on the each of the regulators to explain the reasons for their chosen approach, including how it is justified by their own particular objectives. Rightly or wrongly, the two different scopes proposed by the regulators will be viewed as rival versions.**

40. **The narrowing of the scope of the SMR will have the additional benefit of helping to prevent the SMR from becoming a reincarnation of the APR, whose focus was far too broad, and which had degenerated into a largely pointless box-ticking exercise.**

SMR responsibilities

41. The regulators' July 2014 consultation also set out their plans for identifying responsibilities and allocating them to individuals in the SMR.

42. The Commission said that it should be for banks in the first instance to identify and allocate responsibilities to those in the Senior Managers Regime. This reflected the fact that firms should understand their own businesses better than the regulators, and that each firm will have its own particular structures and activities that need to be incorporated within the SMR. In practice, however, the regulators have set out a list of responsibilities that firms need to allocate to individuals. Firms are able to set their own responsibilities; but there is no obligation for them to do so, nor is there any guidance on whether and when they should. This risks a potential accountability gap, where firms are aware of particular risks—specific to their own business—but do not allocate them to individuals. Should these risks materialise, there is a risk that regulators might struggle to take enforcement action. Moreover, it risks imposing on all banks a single business model designed by the regulator rather than by their directors and managers.

43. **The regulators should reconsider their approach to setting individual responsibilities under the Senior Managers Regime. In particular, they should place a greater obligation on banks themselves to develop and allocate responsibilities to Senior Managers within their firm. Each bank must ensure that responsibility for the structures, activities and risks particular to its own firm are allocated to the right individuals; they will be better placed to do this than the regulators.**

44. **The regulators should ensure that banks identify individual responsibilities of Senior Managers. Any guidance from the regulators on how to draw up these responsibilities should make clear, as the Commission recommended, that the assignment of formal responsibilities should be aligned with the realities of power and influence within a bank and should reflect the operation of collective decision-making mechanisms. Responsibilities drawn up with this principle in mind will be more likely to ensure clarity between different Senior Managers with potentially overlapping remits, for example the Chief Risk Officer and the non-executive Chair of the Risk Committee. The former might be expected to take responsibility for implementing a**

bank's risk framework, while the latter, having no executive responsibility, would be responsible for exercising appropriate oversight of the executive.

45. **It is essential that regulators have regard to the individual characteristics of each business they regulate. Not doing so risks a return to the template-based, box-ticking approach of the Approved Persons Regime, which failed so spectacularly.**

Certification

46. The Act, while implementing most elements of the Certification Regime faithfully, placed responsibility for setting the scope of the regime with the regulators. The PRA and the FCA must, separately, specify which roles within a bank could pose a risk of harm to the bank or its customers. Firms must then pre-approve and monitor individuals performing such roles. In contrast, the Commission said that banks themselves should be able to identify which individuals could pose serious harm.

47. The regulators each set out a proposed scope for their elements of the Certification Regime in their July 2014 consultation. The PRA proposes to use the EU definition of 'material risk taker'— an individual whose actions could have a material impact on the risk profile of the firm—to broadly define the scope of its regime. The PRA's view is that, for prudential purposes, this is the same as the definition of an individual that could cause serious harm to the firm. The FCA proposes to include material risk takers in its Certification Regime, but also to include additional staff relevant to its conduct remit, including:

- Individuals currently classed as 'SIFs' under the APR who will not be covered by the SMR but who are also not material risk takers. Examples would include benchmark submitters.

- Individuals in customer-facing roles which are subject to qualification requirements (for example, mortgage and retail investment advisors).

- Individuals who supervise or manage a certified person, if they are not in the SMR.

48. As described, the Commission's view was that banks should already know which employees could seriously harm the bank, its reputation or its customers through their actions or behaviour; and, if banks were doing their jobs properly, they should already monitor these individuals closely and fully explain to them their contractual responsibilities. The aim of the Certification Regime was to formalise banks' responsibilities for ensuring that staff understand and demonstrate the high standards set out in the regime. It should make clear banks' primary responsibility for taking disciplinary action under an employee's contract of employment when standards are breached. Primary responsibility for implementing and administering the Certification Regime should therefore rest with banks. The role of the regulators, in contrast, was expected to be far less onerous—their job should be to monitor banks' execution of the regime, and take enforcement action where firms are found to be failing in their duties.

49. **Banks should know already which of their staff can cause serious harm to the bank or its customers. They should also be monitoring these staff appropriately. If they are doing their jobs properly, Certification should not therefore place a significant**

additional burden on banks. Certification and the Senior Managers Regime taken together, far from increasing the regulatory burden compared to the Approved Persons Regime, should be capable of reducing it: the regulators will not be responsible for monitoring the conduct of all Certified staff, and instead will focus their efforts on Senior Managers—a far narrower set of individuals than Approved Persons. The regulators' role in Certification should primarily be to make sure firms are fulfilling their duties in respect of the regime—for example, through periodic spot checks, with the exercise of judgement—and to take remedial action where necessary.

50. **Given this division of responsibilities, we question the regulators' method of implementing the Certification Regime. In particular, the regulators propose to set centrally the scope of the regime, by setting out which roles within banks should be filled by individuals who must be approved by the bank before taking up their position, and monitored by the bank thereafter. While the legislation requires the regulators to specify the scope of the Certification Regime in this way, banks themselves should be primarily responsible for identifying the relevant roles in their own individual firms. Any scope proposed by the regulator should be based on a discussion with banks about the identifications they have made, and be sufficiently flexible to account for the differing structures and business models of individual firms.**

Conduct Rules

51. The 'Banking Standards Rules' recommended by the Commission were introduced as 'Rules of Conduct' in the Act. The regulators were given powers to draw up rules about the conduct of bank staff, where this was "necessary or expedient" for the purpose of advancing their objectives. The rules would be written in a way which was readily meaningful for those who must adhere to them, encapsulating expectations about behaviour such as treating customers fairly and managing conflicts of interest.

52. The Commission had originally intended these rules to establish the basic expectations of staff in the Senior Persons and Licensing Regimes, forming the foundation of their understanding for how they were expected to behave. Specifically, the Commission said that it expected the system of licensing administered by individual banks, under the supervision of the regulators, to ensure that all those subject to the Banking Standards Rules were aware of their obligations. The Act, however, allowed a much wider application of the rules—the regulators could potentially make all employees of a bank subject to them, and launch enforcement action in the case of a breach.

53. In their July 2014 consultation, the regulators each set out draft rules and a proposed scope for them. The drafting of the two sets of rules—which heavily overlap in content—appeared broadly in line with the Commission's proposals. The scope, however, was quite different. The PRA proposed that its rules should apply only to Senior Managers and Certified persons, as the Commission envisaged. The FCA proposed to apply its rules more widely: all but 'ancillary' staff—those individuals whose role would be fundamentally the same as it would be if they worked in a non-financial services firm, for example, cleaners and security guards—would be covered by the rules, and could face enforcement action in the event of non-compliance.

54. **The Commission proposed that the regulators set out meaningful rules on the conduct of banking staff, to act as the foundation of their understanding for how they were expected to behave. The draft rules proposed by the regulators appear well-equipped to meet this aim.**

55. **The scope of the rules proposed by the FCA, however, appears questionable. It opens up the risk of enforcement action being taken on a very wide range of individuals, including those not in position to cause serious harm to a firm or its customers—that is, those not in the Senior Managers or Certification Regimes. The FCA might not intend to enforce against junior individuals in practice, and it may be argued that such rules would act simply as a set of values for all bank employees to uphold. But values statements such as this should be the domain of the firm, not the regulator. Nor do they need to give rise to possible enforcement, as do the FCA's proposed rules. We recommend that the FCA revise the scope of its conduct rules, to cover only Senior Managers and Certified staff.**

Abolition of the APR

56. Despite its manifold failings, the Approved Persons Regime remains in place for other financial services firms, including insurers and asset managers. The Commission indeed recommended that the new regimes be put in place for banking alone in the first instance, in part because the Commission's remit was limited to banking, and in part because wider application might have delayed the timescale for banking reform. However, HM Treasury stated that it would be simpler legislatively and operationally to implement the new regimes for all financial services firms. And Clive Adamson, Director of Supervision at the FCA, said that the FCA would have preferred the Senior Managers Regime to apply across the financial services sector. Despite this, the Government ultimately legislated to introduce the Senior Managers and Certification Regimes in the banking sector alone. **The Treasury Committee has recently called for the Government and the regulators to make proposals to abolish the Approved Persons Regime for the rest of the financial services industry. We support this proposal. It could be that, given the differences between banking and other financial services, the most appropriate replacement would be a variant—rather than a simple reproduction—of the Senior Managers Regime. But the appropriate variant is certainly not the Approved Persons Regime: the manifest failings which made the Approved Persons Regime unfit for banks also make it unfit for other financial services firms.**

Remuneration

57. Remuneration, the Commission concluded, lay at the heart of some of banks' biggest problems. Risk and reward were—and remain—misaligned, with banks' remuneration structures providing incentives for poor behaviour, providing rewards when ill-justified. The Commission's proposals were aimed at addressing this misalignment. Setting the right individual incentives is crucial to securing the right behaviour from a bank overall.

58. The Commission made several key recommendations on the structure of remuneration. It concluded that more pay should be in variable form, since this can be adjusted when necessary. It concluded that a significant portion of variable pay should be deferred—in some cases for up to ten years—to allow time for the consequences of an individual's actions to become clear. Only once these consequences are clear should an individual be granted a reward—on this basis, the Commission recommended the development of legal and contractual arrangements, to allow deferred pay to be cancelled should it prove unjustified. In the most egregious cases, the Commission also recommended the 'clawback' of 'vested' pay—pay which has been granted following the end of the deferral period. Pay can be granted in various forms, but the Commission proposed that a lower proportion than currently should be paid in the form of equity, since payment in shares can encourage excessive leverage. These reforms should apply to all Senior Managers and all staff who can cause serious harm to the bank—that is, all Certified persons. Implemented together, the reforms will help to ensure that bank staff are rewarded for the right behaviour, and not for reckless short-termism or excessive risk-taking. Individual incentives will be set accordingly.

59. In March 2014, the PRA published a standalone consultation on clawback of vested remuneration. In July 2014, the regulators published proposals to amend the Remuneration Code to implement the remainder of the Commission's proposals.

Clawback

60. The PRA's initial proposals in March 2014 appeared to go much further than the Commission envisaged, allowing clawback to be applied in the same circumstances as the recovery of unvested remuneration, rather than just in the most egregious cases. In particular, banks would be expected to be able to apply clawback simply when there had been a downturn in the financial performance of the firm, regardless of whether there had been individual wrongdoing. In its July 2014 consultation, the PRA announced that it would narrow the range of circumstances in which clawback would apply, no longer requiring it in the case of a downturn in financial performance.

61. **The Commission's recommendations were for wide-reaching and long deferral, but tightly-drawn clawback. Clawback—recovery of remuneration that has already been paid out—is a draconian tool, and should apply only in the most egregious cases. The PRA's initial proposal would have widened the application of clawback to a far wider set of circumstances than the Commission intended, including when a bank had simply suffered a downturn in its financial performance. This last requirement has now been dropped. We welcome the PRA's decision to narrow the scope of its clawback proposals.**

Deferral

62. In their July 2014 consultation, the regulators proposed longer deferral periods for bankers' variable remuneration. The new proposals would require Senior Managers' variable pay to be deferred over a minimum of seven years, and Certified individuals' pay to be deferred over a minimum of five years. This compares with the minimum of three to five years required for all 'material risk takers' at present.

63. The regulators cite various studies in attempting to quantify the appropriate period for deferral. Some, based on business cycles, suggest deferral periods of between five and eleven years. Others, based on the cycle of credit and financial variables, suggest deferral of eight to eleven years. Studies based on banking scandals and the emergence of conduct failings could suggest much longer deferral of between ten and twenty years.

64. The regulators chose not to set deferral periods for as long as these studies suggest, however, noting that the value of deferred remuneration to the recipient diminishes as deferral periods increase, and that after a point deferral can thus begin to lose its incentive effect. The PRA has also cited the risk that too stringent deferral requirements might simply push up fixed pay. The regulators note, however, that where there is concern that incentives are still inadequate, they can require longer deferral periods on an ad hoc basis using their power to 'impose a requirement' on firms.

65. **We welcome the regulators' proposal to lengthen deferral periods for variable remuneration. However, the periods proposed—of seven years for Senior Managers and five years for Certified persons—are still not as long as may be necessary in some cases. Indeed, the regulators cite analysis suggesting that longer deferral might be needed to match the maturity of rewards to the maturity of risks, given the nature of the business cycle and the emergence of misconduct years after it has taken place.**

66. **The regulators should consider lengthening their proposed deferral periods. If they are wary of imposing a blanket approach, they should not be afraid to use their powers to impose requirements in individual cases where incentives remain misaligned. Should the regulators favour this latter approach, they should set out clear statements of policy describing the circumstances in which their powers might be used.**

Scope of remuneration proposals

67. The Commission recommended that all those in what will now be the Senior Managers and Certification Regimes should be covered by remuneration proposals. In their initial responses to the Commission in October 2013, the regulators were hesitant about this, saying that the scope of the updated Remuneration Code must be restricted to 'material risk takers'—those who, under the definition set by EU regulations, have a "material impact on the risk profile of the firm". Any larger scope would, the regulators claimed, risk going beyond international standards.

68. Since the Commission's final report, the definition of 'material risk takers' has been revised, increasing the number of individuals who are covered by the Remuneration Code. Furthermore, as described above, the PRA has set the scope of its Certification Regime to be largely the same as that of material risk takers, judging the two sets to be broadly equivalent for prudential purposes. But some members of the FCA's proposed

Certification Regime—including, potentially, LIBOR submitters—are not material risk takers. They are therefore likely to fall outside the scope of the reforms. It is important that the remuneration of such individuals meets certain guidelines, since they still have the capacity—by the FCA's admission in including them in the Certification Regime—to cause significant harm to firms and their customers. Their incentives therefore need to be set correctly. The regulators responded to the Commission's initial proposals, however, by saying that the revised Remuneration Code would continue to apply to material risk takers, and that they did not believe the Code should be applied more widely as this would go beyond international standards on remuneration.

69. **The regulators claim that widening the scope of the Remuneration Code beyond 'material risk takers' would go further than international standards. But if the Code remains restricted to material risk takers, some individuals in the Certification Regime will fall outside the scope of the Commission's remuneration reforms. It is important that some standards—even if not those specific measures set out in the Remuneration Code—apply to these staff, because, as implied by their inclusion in the Certification Regime, they could still cause serious harm to their firm or its customers. It is therefore crucial that they are set the right incentives. The regulators should therefore make proposals for applying remuneration standards to those individuals in the Certification Regime who are not material risk takers.**

Payments to bailed-out banks

70. The Commission proposed that, in the event that a bank is in receipt of direct taxpayer support, the regulators should have an explicit discretionary power to render void or cancel all entitlements for payments for loss of office or change of control and all unvested pension rights in respect of those in the Senior Managers and Certification regimes.

71. This recommendation was in part prompted by a number of examples of additional, contractual payments being made to executives and directors amid taxpayer bail-outs. For example, because Fred Goodwin was asked to retire early following the bail-out of RBS in 2008, the value of his pension increased from £8.3 million to £16.6 million, reflecting the full pension rights he would have accrued had he worked until aged 60.[1] Separately, the acquisition of HBOS by Lloyds Banking Group in 2008 resulted in cash awards of over £941,000 becoming available to several HBOS directors, in accordance with contractual entitlements.[2] Despite the acquisition—which was designed to "secure a more stable long-term solution" for HBOS—the Government was forced to inject billions of taxpayer funds into the combined bank just weeks later.

72. A concern of the Commission was that additional, non-discretionary, contractual payments could potentially be made to senior executives and directors, as a direct result of essential steps taken to stabilise the firm following poor management. It was difficult not to view such payments as rewards for failure.

73. In their July 2014 consultation, the regulators proposed to make explicit in the Remuneration Code the presumption that all discretionary payments should be stopped or restricted in the event of a bank receiving taxpayer support. **The regulators should go**

1 PCBS Final Report, para 816; RBS 2008 report page 168

2 HBOS 2008 Annual Report, page 68

further than this. First, there should be a presumption that discretionary payments will be stopped, not simply restricted, in the event of a bank receiving state-funded capital injections. Second, the regulators should have the power to void not only discretionary payments, but also additional, contractual payments which are in effect triggered by the failure of the firm, in the event that a bank is in receipt of state-funded capital support. The regulators will need to exercise judgement when using this power: it should not, for example, be used in cases where new management has been installed in a bank just prior to a bail-out, in an attempt to turn the firm around, but has been—through no fault of its own—unable to do so. There may be other cases. The power should be exercised to put into effect the clear principle that there must be no rewards for failure—and that taxpayer funding for such rewards would be particularly unacceptable.

Competition

74. Competition has a crucial role to play in enhancing banking standards and consumer outcomes. Greater market discipline can help address the consumer detriment and lapses in standards that result from lack of sufficient choice or proper information. The Commission therefore made a number of recommendations designed to increase competition in the banking sector.

Regulation and competition

75. On the regulatory front, the Commission concluded that the FCA needed to embed within itself a robust pro-competition culture. While the FCA had competition powers at the time, the Commission was concerned for a number of reasons that it may fail to use them. A pro-competition culture should help to ensure the FCA looks to competition as a primary mechanism to improve standards and consumer outcomes. The Commission also recommended that the PRA should have a secondary competition objective, considering that the requirement on the PRA at the time simply to 'have regard' to competition did not go nearly far enough, and risked competition being neglected altogether. This would have been of great concern given the potential for prudential requirements to act as a barrier to entry.

76. Well over a year on, there has been some progress. The Government legislated to grant the PRA a secondary competition objective in the Financial Services (Banking Reform) Act, and this took effect in March 2014. The PRA has commenced a programme of work to ensure this objective is reflected in its decision-making. The FCA, meanwhile, has reiterated its commitment to embedding a pro-competition culture, and is constructing a team with competition expertise, providing training to staff and reviewing its rules and procedures to ensure that they promote competition. The FCA has also stated its commitment to help shape a market that offers consumers alternatives—including from new models such as peer-to-peer lending—and said that competition should factor in every decision, in every rule, in every action it takes.

77. **The regulators' stated commitment to competition, and the steps they have taken so far to promote it, are welcome. But it is still too early to judge the effect of these changes. A guiding principle is that competition should be integral to every aspect of regulatory behaviour. It is important that it is not delegated to a single arm of either regulator. The FCA's stated aim to factor 'competition thinking' into all of its decisions, rules and actions, is welcome and essential. Parliament should do what it can to hold the FCA to this commitment.**

78. **Too much regulation can increase barriers to entry and stifle competition. In making this observation it is important to distinguish between two distinct forms of regulatory burden—financial and administrative.**

79. **Banks may squeal at the prospect of increased capital requirements, but they need to be well-capitalised to protect customers, and the taxpayer. In any case, the regulators now authorise new banks with reduced capital requirements, recognising the need for**

barriers to entry to be low and the lesser risk that small new entrants pose to financial stability.

80. **The administrative burden of regulation can also be high, however, and may risk increasing barriers to entry. The regulators and Parliament should be alert to this risk, to the adverse effect it could have on competition, and to the risk it could pose in turn to standards in the banking sector.**

The CMA market investigation and other developments

81. The Commission also examined the state of competition in the retail and SME banking sector. In January 2013, the Office of Fair Trading (OFT) had described "significant concerns about the effectiveness of competition" in the personal current account market: concentration levels had increased since 2008, there was a lack of consumer engagement and, combined with a lack of confidence in the process for account switching, this meant that consumers were not driving effective competition between providers. But the OFT had stopped short of making a market investigation reference to the Competition Commission with respect to UK banks, since a number of reforms—including the 7-day switching service and the Lloyds divestment—were about to take effect. In addition, the Financial Services Authority—the predecessor to the FCA and the PRA—was nearing the completion of its review of barriers to entry in the banking sector, which was ultimately published in March 2013. The FSA's commitment, as set out in this review, to reform its authorisations process—which had previously been overly conservative in its treatment of new entrants—was welcomed by the Commission.

82. The Commission considered the case for making a market investigation reference in respect of UK banks. But it concluded that a large number of regulatory reforms to the banking sector were already in progress, that an immediate Competition Commission referral would further add to the burden of uncertainty on the sector, and that reform measures already in train would significantly increase competition in the sector. On this basis, the Commission chose not to recommend an immediate market investigation reference, but instead proposed that the Competition and Markets Authority (CMA)—the successor body to the OFT—carry out a market study of the retail and SME banking sector. This study was to be completed on a timetable consistent with making a market investigation reference, should the CMA so decide, before the end of 2015.

83. Some signs of progress in the retail banking market are visible. A number of challenger banks have entered the personal current account market in recent months, and further new entrants are expected. At the time of the Commission's final Report, the Verde transaction had not long fallen through, delaying the EU-mandated divestment of a number of Lloyds Banking Group branches. Now the divestment is in train: TSB is mounting its own challenge in the current account market and an initial tranche of shares has already been issued.

84. The Current Account Switching Service (CASS)—which the Commission welcomed, saying that it should improve the switching process for consumers and increase the level of competition in the current account market—launched in September 2013. Research from the Payments Council suggests that awareness of and satisfaction with the new service is high. This appears to be an encouraging start.

85. It remains to be seen whether the challengers will represent a serious threat to the incumbents, however. Just as a number of measures are required to increase competition in banking, a number of metrics are required to gauge the extent of competition. Despite some encouraging signs, concerns remain.

86. Shortly after the publication of the Commission's final report, the OFT announced a market study into competition in banking for SMEs. In March this year, it was announced that this work would be extended to include the personal current account market, updating the OFT's findings from January 2013. The CMA inherited this portfolio of work upon its inception and, in July 2014, announced its preliminary decision to refer the markets for personal current accounts and SME banking for a market investigation. Following consultation, the CMA is set to announce its final decision shortly.

87. **Greater competition in the banking sector since the Commission's final Report has been elusive. Much more remains to be done.**

88. **The Commission identified many failings with competition in the banking industry. However, it initially refrained from recommending an immediate market investigation reference for the UK banking sector, in large part because a number of pro-competitive changes—including the FSA's revised approach to authorising new entrants, and the current account switching service—had not long come into effect when the Commission reported, and had not had a chance to have a positive effect. One year on from the publication of the Commission's final report, in spite of the reforms implemented in 2013, the CMA concluded that the market was still not functioning properly, and made a provisional decision to call for a full market investigation. We strongly welcome the CMA's provisional decision.**

Basic bank accounts

89. As well as operating in a competitive market, banks also play a vital utility role: the Commission concluded that banking the unbanked should be a customer service priority for the banking sector. The Commission therefore recommended that the major banks to come to a voluntary arrangement to set minimum standards for the provision of basic bank accounts. In the event that the industry was unable to reach a satisfactory voluntary agreement on minimum standards of basic bank account provision within the year, the Commission recommended that the Government introduce, in consultation with the industry, a statutory duty to open an account that will deliver a comprehensive service to the unbanked, subject only to exceptions set out in law. The Government said in July 2013 that it was taking forward discussions with the banking sector and would provide further details later in the year. No details have yet emerged, however.

90. The failure of previous industry talks on the provision of basic bank accounts, and the apparent unwillingness of some banks to engage constructively in coming to an agreement, was a cause for concern to the Commission. **We remain concerned: well over a year on from the Commission's final Report, inadequate progress has been made. The Treasury Committee is currently inquiring into the treatment of consumers by the financial services industry, including the provision of basic bank accounts. The Treasury Committee should request an update, as part of this work, from banks and the Treasury on what steps have been taken towards the Commission's recommendation.**

Better regulation

91. Banking standards will greatly benefit from the restructuring of banks, from strong competition, if it develops, and from appropriate individual incentives among banking staff. But good regulatory judgement will remain necessary, and the need for enforcement on occasion cannot be ruled out.

Enforcement

92. The Commission was concerned that the right balance between the use of enforcement and supervisory powers was not being struck, and that the existing arrangements for enforcement in financial services were a factor in this. The Commission was concerned that the body responsible for reaching enforcement decisions arising from the work of the FCA—the Regulatory Decisions Committee (RDC), a committee of the FCA Board—was not best-suited to the specific enforcement needs of the banking sector. Its composition seemed to offer the worst of all worlds; it appeared to contain neither a depth of banking expertise nor a clear lay element separate from banking and allied financial services sectors. The Commission therefore recommended a new decision-making body, with statutory autonomy within the FCA, which would have a lay (non-banking or financial services professional) majority, but also contain several members with extensive and senior banking experience. The body would be chaired by someone with senior judicial experience.

93. During the passage of the Financial Services (Banking Reform) Act 2013, the Government agreed to a review of the enforcement arrangements for the financial services sector. This was launched by the Treasury in May 2014, and the consultation phase concluded in July 2014. As the Treasury now considers responses to its review, it must have in mind a number of crucial questions: whether the arrangements for enforcement currently lead to an appropriate balance between the use of supervisory and disciplinary powers; whether there is currently an appropriate separation between those investigating a case and those making a final decision on it; whether the current system allows those accused of regulatory infractions, particularly smaller practitioners, an appropriate opportunity to put their case across; and whether there would be benefit in a separate statutory body for enforcement in the financial services sector as a whole. **We expect the Treasury to consider these questions when determining its response to the consultation. It must pay particular attention to the question of whether the regulators are striking the right balance between the use of supervisory and enforcement powers. If there is a risk that this is not the case—or a risk of the perception that it is not—the Treasury may need to propose changes to the current structure for enforcement to address the problem.**

94. **The Commission's intention was that the new decision-making body to replace the RDC should deliberate on enforcement decisions. There may also be merit in such a body monitoring executive settlements, on a sample and possibly a confidential basis. Such an arrangement would bring a level of external review to the settlement process that is currently lacking compared to the full enforcement process, where cases may be referred to the Upper Tribunal. This would help to provide more credibility and confidence in what is a very common route to the closure of enforcement action—58%**

of enforcement cases closed between 2010–11 and 2012–13 were concluded by executive settlement.[3] The Treasury should consider this in its enforcement review, and also consider whether the new body should also examine settlement decisions involving the PRA.

95. The regulators have a powerful new tool in the reversal of the burden of proof. It will help them to take civil enforcement action against senior individuals when serious failings occur—something they appeared powerless to do following the financial crisis. The regulators must exercise judgement when determining the trigger for this new tool: they must first determine that a regulatory breach has occurred; and they must then determine that a particular senior individual was responsible for the bank's activities in relation to that breach. Given the strength of the tool, there is a responsibility on regulators to demonstrate care in reaching these judgements. Only time will tell if they do. **Were it to appear over time that the regulators—even after any reforms consequent upon the Treasury's enforcement review—were not taking sufficient care in exercising their judgement about when to trigger the reversal of the burden of proof, there might be a need to consider some preliminary scrutiny of their decisions. This would need to occur prior to referral to the Upper Tribunal, with its attendant costs.**

Mis-selling at the point of sale?

96. Those who design and market products should be held responsible should those products be mis-sold to consumers. There should be a particular duty on banks to test thoroughly what might go wrong with new products before their launch. But the Commission was concerned to ensure that—so long as such precautionary steps were taken—the mere discovery of risk in products should not be held to constitute mis-selling, where such risks could not reasonably have been foreseen at the time that they were sold.

97. In this respect, it is essential that the FCA does not act retrospectively, applying different standards or interpreting rules differently with hindsight. The FCA has confirmed that retrospective action of this sort is not its regulatory intent, and that the requirement only to act on a reasonable interpretation of the rules and principles that were in force at the time any mis-conduct occurred is 'hardwired' into its formal rules and guidance. The FCA also makes explicitly clear in its enforcement guide that firms must be able reasonably to predict, at the time of specific conduct, whether that conduct would breach the FCA's 'Principles for Business'; and that the FCA will not take enforcement action unless it was possible to determine at the time that the relevant conduct fell short of regulatory requirements.

98. In August 2014, however, the FCA launched a 'Call for examples', requesting views from the industry on when the FCA, and its predecessor the FSA, had applied its rules retrospectively. It also requested other feedback or suggestions from the industry on the issue of retrospection. The FCA is now considering responses.

99. **The FCA has said that it is not its intention to interpret its rules and principles retrospectively. The FCA should consider carefully the responses to its 'Call for examples' on retrospective action, to confirm that the industry perception matches this**

3 https://www.gov.uk/government/consultations/review-of-enforcement-decision-making-at-the-financial-services-regulators-call-for-evidence/review-of-enforcement-decision-making-at-the-financial-services-regulators-call-for-evidence

intent. If it does not, the FCA must consider what more it needs to do to avoid the risk of acting retrospectively.

100. **Explicit provisions in the FCA enforcement guide already make clear that the FCA will not take enforcement action unless it was possible to determine "at the time" that any relevant conduct fell short of its requirements. This goes some way to addressing the Commission's concern that the mere discovery of risk in products should not be held to constitute mis-selling, where such risks could not reasonably have been foreseen at the time that they were sold. The FCA should bear in mind, however, that it and firms may independently form different judgements as to what was reasonably foreseeable at any point. Clear regulatory guidance and consistency in regulatory action will be needed to help align expectations on both sides.**

Leverage ratio

101. Regulators need the right tools to be able to manage risks to their objectives. The Commission considered that a leverage ratio tool was an important part of banks' total capital requirements, since reliance on risk-weighted capital requirements alone was dangerous. The Commission further felt that the power to determine the leverage ratio—a complex and technical decision—should rest with the Financial Policy Committee (FPC), not with politicians, and in its first Report in December 2012 recommended that the FPC be granted the power to set the leverage ratio by spring 2013.

102. The Government initially rejected this proposal outright, saying that it planned to hand the leverage ratio power to the FPC no earlier than 2018, and that even this would be subject to a review in 2017 to assess progress on international standards. This, the Government said, was to ensure that the UK leverage ratio was consistent with international norms, which were still under development. In its final Report in June 2013, the Commission called on the Government to reconsider its decision. In response, Government said merely that it was still appropriate to grant the FPC the power from 2018, subject to a review in 2017.

103. However, in November 2013, following debate on the Financial Services (Banking Reform) Bill in the House of Lords, the Chancellor agreed to hand the leverage ratio power to the FPC. This would follow a review, by the FPC, of how the tool would be used. The FPC conducted its review over summer 2014, and reported its findings on 31 October 2014. The FPC recommended that the Treasury grant it a power of direction over the minimum leverage ratio, a supplementary leverage ratio buffer applicable to systemically important and other major domestic UK banks and building societies, and a countercyclical leverage ratio buffer to account for systemic risks attributable to credit booms. The FPC also decided to set the minimum leverage ratio at 3 per cent. The 3 per cent minimum and the countercyclical buffer for systemically important firms and other major UK banks and building societies will come into effect immediately, while other elements of the framework will be phased in over 2015 to 2019. The Chancellor agreed to take forward legislation to hand the FPC the necessary powers in this Parliament.

104. **The setting of the leverage ratio is a complex and technical decision; one best made by the regulator. We therefore strongly welcome the FPC's recommendation that the Treasury hand the Bank of England powers of direction over the leverage ratio, and**

also the Chancellor's commitment to deliver these powers in this Parliament. The public now relies on the FPC to exercise judgement in setting the leverage ratio high enough to protect financial stability, but not so high that it unnecessarily constrains borrowing or economic growth.

Regulatory accounts

105. Flaws in the IFRS system of accounting mean that it is not fit for the regulators' purposes. The Commission therefore recommended the creation of a separate set of accounts for regulators. The Bank of England has agreed to consider this recommendation and will consult by the end of the year on whether to proceed with the proposal. **We remain convinced of the need for a separate set of regulatory accounts. We await the Bank's consultation.**

Regulatory fees

106. The Commission noted the stated intention of the Bank of England that the PRA would operate, in the medium term, at a lower running cost than its equivalent part of the FSA. The former Governor of the Bank, Lord King, believed that the PRA could "operate prudential supervision at lower cost than hitherto by reducing the burden of routine data collection and focussing on the major risks to the system".[4]

107. The Commission recommended that the FCA should replicate the Bank of England's intention, and make a commitment to operate at a lower cost than its equivalent part of the FSA. Importantly, the Commission said this would exclude what was required to fund the FCA's new responsibilities.

108. The FCA responded with a commitment to operate 'legacy work' within its equivalent FSA budget of £446 million for the year 2014/15. It noted, however, that it would require additional funding for its new responsibilities, including its competition objective and regulation of consumer credit. In particular, in March 2014 it said it would need an additional £6 million to carry out work in respect of its competition objective.

109. **The Treasury Committee will need to monitor the regulators' commitments on operating costs. In doing so, the exercise of judgement will be needed on what constitutes the cost of regulation—for example, whether it comprises only regulatory fees, or whether it extends also to the cost of work, commissioned by the regulators under Section 166 of FSMA 2000, but funded by regulated firms, which would normally have been covered by the regulatory levy.**

The HBOS review

110. In its fourth report, the Commission considered the failure of HBOS. Among its key recommendations were that certain matters should be examined further by the regulator's own HBOS inquiry.

111. The Terms of Reference of the regulatory HBOS inquiry, published in June 2014, made clear that these matters will indeed be examined. This is welcome. **We look forward**

4 Speech by Lord King at the Lord Mayor's dinner for bankers and merchants of the City of London, Mansion House, London, 15 June 2011

to the report of the regulatory inquiry on HBOS, which will help to ensure that lessons are learned from past failures.

Maintaining momentum behind the reforms

112. In its final Report, the Commission concluded:

> Reform across several fronts is badly needed, and in ways that will endure when memories of recent crises and scandals fade.

Almost 18 months on, there are already signs that memories of the events that prompted the creation of the Commission are growing hazy, and that, as banks recover their strength and self-confidence, their support for reform is also growing weaker.

113. Some scepticism of reform is based in part on misrepresentations—inadvertent or otherwise—of some of the Commission's proposals. Some ill-informed commentary has confused the new criminal sanction for reckless mismanagement and the reversal of the burden of proof in civil misconduct cases. This cannot stand uncorrected. The burden of proof will <u>not</u> be reversed for the new criminal sanction—the burden of proof will rest, as it always does in criminal cases, with the prosecution. The Commission did not recommend the reversal of the burden of proof for the criminal sanction, nor did the Government legislate for it. The reversal of the burden of proof applies only in <u>civil</u> misconduct cases brought by the regulators in respect of members of the Senior Managers Regime.

114. Some commentary has also suggested that our reforms will lead to overly risk averse behaviour. If they are properly implemented, this should not be the case. Our reforms are simply designed to ensure that individuals are set the right incentives, and that they bear responsibility for their actions. Senior individuals may face tough sanctions. But these will be in proportion to the responsibility they choose to taken on, to any rewards they gain in so doing, and to any wrongdoing they commit.

115. Without question, the criminal sanction presents a forbidding prospect for senior bankers—indeed, it was designed to do so. But the bar for the offence is set extremely high: it will apply only in cases where a bank fails as a direct result of behaviour by an individual whose conduct falls far below what could reasonably be expected of them. Even as it recommended the criminal sanction, the Commission was under no illusions about the difficulties of securing a conviction for the offence. But it understood the value the sanction would have in focusing minds.

116. Accepting the consequences of one's actions may be an unappealing prospect to some. But it is the nature of responsibility. The old system failed—maintaining it is not an option.

117. A great deal of progress has been made since the Commission's final Report. The Commission's inquiry was fundamentally different from other reviews, since its members, as legislators, were able to assist the process of implementing its proposals in statute. This process began with the Commission's second Report, which not only included policy proposals but also recommended draft text for amendments. Following publication of their final Report, former Commissioners helped to secure legislative backing for the proposals in the Financial Services (Banking Reform) Act 2013. Electrification, independent reviews of ring-fencing and proprietary trading, the new regulatory regimes for individuals and

new sanctions for senior bankers now all have a statutory footing. Secondary legislation has further defined the ring-fencing regime. The regulators have made considerable progress on the detailed design of new remuneration requirements and the Senior Managers and Certification Regimes.

118. The regulators' proposals require some amendment and, once this is complete, banks must engage fully with the task of implementing them. There is much work still to do—a necessary condition for the restoration of trust.

Mr Andrew Tyrie MP

Most Rev and Rt Hon the Archbishop of Canterbury

Mark Garnier MP

Rt Hon Lord Lawson of Blaby

Mr Andrew Love MP

Rt Hon Lord McFall of Alcluith

John Thurso MP

Lord Turnbull KCB CVO

4 November 2014