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Seventh Report of Session 2014–15

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Treasury Committee

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1 Introduction

The work of the Parliamentary Commission on Banking Standards

1. The Parliamentary Commission on Banking Standards (PCBS) was set up by both Houses of Parliament in July 2012 "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".[1]

2. The PCBS issued its fifth and final Report, *Changing Banking for Good,* on 19 June 2013.[2] This followed other Reports from the PCBS which examined the draft Financial Services (Banking Reform) Bill,[3] the question of proprietary trading by banks,[4] and the failure of HBOS.[5]

3. The Government responded to the PCBS on 8 July 2013.[6] The Bank of England and the Financial Conduct Authority (FCA) responded to the PCBS's recommendations on 7 October 2013.[7]

This Report

4. Parliamentary responsibility for following up the recommendations of the PCBS rests with the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee.

5. This Report assesses the extent to which the Government and the regulators have undertaken to implement the PCBS's recommendations. Some recommendations have been enacted through the Financial Services (Banking Reform) Act 2013, which received Royal Assent on 18 December 2013 after extensive amendment in Parliament, but details of the implementation of some statutory provisions are still emerging. This Report also discusses the PCBS's recommendations which will fall to the regulators to implement under their existing powers.

1 Votes and Proceedings, House of Commons, 16 July 2012; House of Lords Journal, 17 July 2012

2 Parliamentary Commission on Banking Standards, *Changing banking for good*, Session 2013–14, HL Paper 27/HC 175

3 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848; Second Report of Session 2012–13, *Banking reform: towards the right structure,* HL 126/HC 1012

4 Parliamentary Commission on Banking Standards, Third Report of Session 2012–13, *Proprietary trading*, HL Paper 138/HC 1034

5 Parliamentary Commission on Banking Standards, Fourth Report of Session 2012–13, *'An accident waiting to happen': the failure of HBOS*, HL Paper 144/HC 705

6 HM Treasury and Department for Business, Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards,* Cm 8661, July 2013

7 Bank of England, *Bank of England response to the Final Report of the Parliamentary Commission on Banking Standards*, 7 October 2013; Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, 7 October 2013

2 Why the PCBS was necessary

Creation of the PCBS

6. The PCBS was created in the wake of the exposure of the manipulation for private advantage of the London Interbank Offered Rate (LIBOR) in late June 2012. The reputation of the banking industry had already been damaged by a string of mis-selling scandals and the need for UK taxpayers to bail out major institutions. The LIBOR scandal, however, made the industry appear not just incompetent, but, in the words of the PCBS, "morally bankrupt".[8] There was a general acceptance that standards in the banking industry were low, that a wide-ranging examination of them was needed, and that far-reaching reform would have to follow. Parliament's response was to create the PCBS.

The problems of the banking industry

7. The PCBS recognised the crucial role that banks play in the economy, but concluded that the malaise in the banking industry was both deep-seated and the result of a combination of separate causes:

- Bankers, regulators and politicians had failed to learn the lessons of past failures born of hubristic expansion and unsustainable asset price bubbles;
- The implicit taxpayer guarantee that made banks too important to fail and too complex to resolve, and which, among other harmful effects, gave them incentives to take excessive risks;
- Banks had become too big and too complex to be managed effectively. This made it more likely that a bank's standards would be low, but also gave banks' leaders a convenient excuse of ignorance when scandals were discovered. Complexity therefore undermined the personal responsibility of senior executives;
- Senior bankers continued to be paid more than could be justified by their performance, and incentives were preoccupied with short term leveraged growth with inadequate consideration of long term risk;
- Banking culture often lacked a sense of duty to the customer or of collective responsibility for the reputation of the industry;
- Banks' internal compliance systems were ineffective;
- Regulation of the banking industry was misconceived and poorly targeted, and too narrowly rule-based rather than judgement-based;
- Retail banking, owing to high market concentration and substantial barriers to entry, lacked competitive pressures. This, combined with the information disparity between banks and consumers, meant that banks had weak incentives to reduce prices and improve customer service;

8 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 2

- Institutional shareholders had incentives to encourage banks to pursue high risk strategies in pursuit of short-term returns; and
- Distorted incentives in banking gave large rewards for short-term success, incentivising risk on the balance sheet.

The PCBS's conclusions and recommendations

8. The PCBS concluded that the reforms to bank regulation already in train would be inadequate to eliminate fully the taxpayer guarantee. They would also fail to remedy the underlying causes of poor standards and culture.

9. The PCBS's recommendations had five major themes:

- Reinforcing the ring-fencing changes to banks originally set out in the report of the Independent Commission on Banking led by Sir John Vickers;
- Making a reality of individual responsibility, particularly at senior levels;
- Improving competition;
- Creating much more robust and effective corporate governance structures, and
- Giving regulators the powers they needed while holding them to their task.

3 The response of the Government and the regulators

Initial responses

10. The Government's initial response to the PCBS's final Report was positive, giving the impression that the Government was accepting, and would implement, the great majority of its proposals. This message was reinforced by the Chancellor's Mansion House speech in June 2013, a week after publication of the PCBS's final Report.[9]

11. The Bank of England and the Financial Conduct Authority (FCA) responded to the PCBS in October 2013.[10] The Bank of England welcomed the report and said that, "with a few exceptions, [we] intend to take forward its recommendations".[11] The FCA said that it intended to take forward "the majority of these recommendations".[12]

12. In particular, the Government and the regulators initially promised to implement the following important recommendations:

- A new regime for senior bankers, to be called the Senior Managers Regime, to impose meaningful lines of personal accountability and enforceable sanctions within banks;
- A new criminal sanction for reckless misconduct in the management of a bank;
- Giving the Prudential Regulation Authority a new secondary competition objective; and
- A review of the case for splitting RBS into a 'good' and 'bad' bank.

Inadequacies in the initial responses

13. Despite the positive tone of the responses from the Government, a great many of the PCBS's recommendations were either not initially accepted by the Government, or the means of implementing them were inadequate. Former members of the PCBS attempted, during the passage of the Financial Services (Banking Reform) Bill through both Houses of Parliament, to remedy these omissions and to provide a statutory basis for implementing PCBS recommendations. In the following cases they were successful:

- The original Government proposal—tabled in the form of an amendment at Commons Report stage—for the so-called 'electrification' of the ring fence, to give regulators reserve powers of separation to discourage banks from gaming the ring fence bank, was inadequate: it would have been so difficult and slow to use that it would have not have been a deterrent to banks. It required the regulator to issue no fewer than three

9 Speech by Chancellor of the Exchequer, Rt Hon George Osborne MP, Mansion House, 19 June 2013

10 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*; Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013

11 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, para 3

12 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, para 3

preliminary notices and a warning notice before it could act. It also required the regulator to seek permission from the Treasury three times before acting. It would, further, have allowed at least five years for the separation to take place even after the regulator had ordered it. The proposal also contained no provision for a review of the case for full separation of the banking sector as a whole.

- There was no provision for a review of proprietary trading.
- There was nothing to implement the PCBS's recommendations for a licensing regime to cover individuals outside the Senior Managers Regime whose actions could seriously harm the bank, its reputation or its customers.
- The Bill originally defined a bank in a way that would have excluded some major investment banks.

These successes are described in the chapters which follow.

14. However, former Commissioners did not succeed in persuading the Government to implement the following PCBS recommendations via the Bill:

- PCBS proposals for reform of Bank of England governance, including: creating a proper board to supervise the Bank; and relieving the Governor of the Bank of England of the position of Chair of the Prudential Regulation Authority;
- Abolition of UKFI;
- Abolition of the FCA's overarching strategic objective of "ensuring that the relevant markets function well", on the grounds that it was unnecessary and that it might divert the FCA from its core operational objectives;
- Placing a duty upon regulators to compensate whistleblowers disadvantaged by their firms; and
- Placing a duty upon the Governor of the Bank of England to raise the alert if he believed that there was excessive lobbying by banks.

Non-statutory implementation of PCBS recommendations

15. A number of undertakings and assurances were also given by Government and the regulators in response to PCBS recommendations which did not require legislation:

- The Bank of England would in 2014 examine the case for a power to set a minimum leverage ratio for the banking sector and the Government said that it would then legislate;
- The PRA and FCA stated that they would act if necessary to put a bank about which they have concerns into 'special measures' in order to improve standards;
- The Treasury has consulted on the system of enforcement decision making in financial services; and

- The PRA committed itself to aligning the maturity of rewards for bankers to the maturity of the risk they have incurred. In July 2014, the PRA and FCA jointly published proposals for amending the Remuneration Code to reflect the PCBS's proposals.

Recent developments

16. Since the Act received Royal Assent, the regulators have come forward with detailed proposals to implement various recommendations, both those with and without specific statutory underpinning. In particular:

- In July 2014, the PRA and FCA published proposals on the implementation of the new regulatory regimes for individuals;[13]
- In July 2014, the PRA and FCA published proposals to amend the Remuneration Code to reflect the PCBS's recommendations on banking sector remuneration;[14]
- In October 2014, the PRA consulted on some aspects of the implementation of ring-fencing.[15]

The statutory implementation of the PCBS's proposals is considered in Chapters 4 and 5 of this Report. Progress with the non-statutory implementation of some of the most important PCBS recommendations is discussed in Chapter 6.

13 Financial Conduct Authority and Prudential Regulation Authority joint consultation paper, *Strengthening accountability in banking: a new regulatory framework for individuals*, FCA CP14/13/PRA CP14/14, July 2014

14 Financial Conduct Authority and Prudential Regulation Authority joint consultation paper, *Strengthening the alignment of risk and reward*, CP15/14, FCA CP14/14, July 2014

15 Prudential Regulation Authority consultation paper, *The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities*, CP19/14, October 2014

4 'Ring-fencing' and proprietary trading

Background: recommendations of the Independent Commission on Banking, the draft Bill and pre-legislative scrutiny by the PCBS

18. In September 2011, the Independent Commission on Banking (ICB), set up by the present Government and led by Sir John Vickers, published its Final Report. The ICB recommended that, where continuous provision of service was vital to the economy and to a bank's customers, retail banking activities should be 'ring-fenced' from other activities, making it easier to resolve banks that get into difficulty without the need for taxpayer support.[16]

19. In response to the ICB's recommendations, the Government published a draft Financial Services (Banking Reform) Bill, the scrutiny of which was entrusted to the PCBS.[17] The draft Bill introduced a basis for partial structural separation of the banking system by ring-fencing the core activities of a bank (which the ICB referred to as "mandated activities") in order to protect them from the more risky activities connected with wholesale and investment banking. "Core activities" amounted simply to deposit-taking, but the draft Bill left open the option for the Treasury to add to the list of core activities in the future in response to changing economic circumstances.[18]

20. In its scrutiny of the draft Bill, the PCBS welcomed the Government's approach but considered that a new statutory regime should go further.[19] It believed that regulators should be provided with reserve powers to implement full separation of banks in the event that ring-fencing proved to be ineffective. The PCBS therefore recommended that the legislation contain a "first reserve power" to enable the regulator to require of an individual banking group full separation of the ring-fenced entity from the rest of the banking group. A "second reserve power" would make possible full structural separation across the sector as a whole. The PCBS recommended that this latter, wider, power be contingent on the recommendations of an independent review of the ring-fencing regime and would require further, secondary, legislation for its implementation.[20]

21. The First Report of the PCBS made clear that this 'electrification' of the ring-fence was intended as a deterrent against gaming of the ring-fence by banking groups.[21] The PCBS considered that electrification was necessary in the context of an industry notorious for innovative methods of circumventing regulation.[22] The Second Report of the PCBS stated that:

16 Independent Commission on Banking, *Final Report*, September 2011

17 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012

18 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.22

19 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, paras 93 and 94

20 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, paras 164–171

21 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 163

22 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, paras 7–9; Q948

> Our intention in our specific proposals for 'electrification' of the ring-fence was to create a significant new disincentive for banks seeking over time to test the ring-fence with a view to undermining its effectiveness. This disincentive was in the form of powers to enforce full institutional separation at the level of individual banks or the sector as a whole.[23]

The PCBS recommendations

First reserve power: separating individual banking groups

22. The PCBS recommendation for the first reserve power called for:

> [...] powers for the regulator to take steps that could lead to a specific banking group affected by the ring-fence being required to divest itself fully of either its ring-fenced or its non-ring-fenced bank.[24]

23. Its second report asked for a further power, recommending that the "Government make explicit provision in the Bill to enable the regulator to require a bank to divest itself of a specified division or set of activities which would fall short of the full divestment required under the first reserve power".[25] This power could be exercised:

> [...] if the regulator had concluded that the conduct of the banking group was such as to create a significant risk that the objectives of the ring-fence would not be met in respect of that bank. In these circumstances the regulator should consider the group's adherence to the principles and spirit of the ring-fence as well as its compliance with the letter of the law.[24]

24. The PCBS recommended in its first report that, given the significance of the first reserve power, a number of safeguards and restrictions should be put in place. The power was to not be exercisable by the regulator until after the completion of an independent review of the effectiveness of the ring fence (see further below). This was to be completed within four years of the ring-fencing rules coming into force.[26] The PCBS set out further safeguards, which included:

- a requirement to give a banking group early notice of the intended use of the reserve power;
- opportunities for the banking group to make representations and appeals;
- a requirement to have an external reviewer, approved by the Treasury, to consider the standards and conduct of the bank, its relationship with the regulator and any potential for discriminatory conduct by the regulator;

23 Parliamentary Commission on Banking Standards, Second Report of Session 2012–13, *Banking reform: towards the right structure*, HL Paper 126/HC 1012, para 8

24 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 165

25 Parliamentary Commission on Banking Standards, Second Report of Session 2012–13, *Banking reform: towards the right structure*, HL Paper 126/HC 1012, para 19

26 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 166

- a requirement for Treasury approval for any proposal by the regulator to separate a banking group; and
- A requirement for publication of the notices and decisions of the regulator and Treasury.[27]

Second reserve power: sector-wide separation

25. In its First Report, the PCBS recommended a second reserve power to "implement full separation" of "the sector as a whole."[28] This power could only be exercised as a result of a recommendation of the independent review of the effectiveness of the ring-fencing regime (see further below). Referring to its First Report, the PCBS stated in its Second Report:

> Alongside our proposal for a group-specific regulatory power to enforce full structural separation, we recommended that the independent review should be required to assess the case for a move to full separation across the banking sector as a whole. To strengthen the hand of the review in considering this issue, we recommended that legislation to give effect to any such recommendation should be included in the Bill now before Parliament.[29]

Reviews of ring-fencing

26. The PCBS recommended two different sets of reviews of the ring-fencing regime. First, it recommended that the PRA report annually on the operation of the ring-fence in order to shed light on any issues arising between banks and the regulator and to provide an opportunity to expose attempts by banks to circumvent the system. The recommendation specified that the PRA should:

> [...] publish a statement which summarises how the ring-fencing rules have been implemented by the industry with specific consideration being given to how the position of the ring-fence has evolved, primarily focusing on what activities and services, in addition to the core activities and core services, sit within the ring-fenced bank and to the type of derivative products are being offered by the ring-fenced banks.[30]

27. Second, the PCBS recommended a statutory requirement for periodic, independent reviews of the effectiveness of a new ring-fencing regime, the first to be carried out after four years and each subsequent review to be carried out at five-year intervals. Statutory provision should be made:

- for the review's terms of reference, which should be based on the statutory objectives for the ring-fence and which should require the review body to express a view on

27 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, paras 167–168

28 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, paras 164–165

29 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 171

30 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 171

whether ring-fencing was achieving those objectives and to assess the case for a move to full separation across the banking sector as a whole; and

- to require the review body to make recommendations to the regulator and the Treasury about the design and application of secondary legislation and ring-fencing rules.[31]

28. The PCBS envisaged that the independent review would draw on the work and reports of the PRA in coming to its conclusions. The PCBS stated that:

> If the first review does not lead to full separation, second and subsequent reviews should also draw upon the regulator's accounts of experience in relation to the first reserve power [...] Significant use of this reserve power would indicate that full separation across the banking sector would be very likely to be the appropriate step.[32]

Government response to the First Report of the PCBS

29. The Government, as part of its response to the first PCBS report, supported the creation of a reserve power for regulators to separate individual banking groups (the first reserve power) and for the PRA to conduct annual reviews into the operation of the ring-fence. It said in its response to the PCBS:

> The Government agrees with the PCBS that it is essential to preserve the robustness of the ring-fence, and that a reserve power to require an individual banking group to move to full separation of retail and wholesale activities could be a powerful additional tool for the regulator to ensure the independence of a ring-fenced bank. The Government will therefore amend the Bill to include provisions giving the regulator the power to enforce full separation between retail and wholesale banking in a specified group. To ensure that such a substantial regulatory power is not used lightly, strict statutory conditions will be established setting out the circumstances in which this power can be used, tests that must be met and factors the regulator must take into account before deciding to require a group to separate. Given the potential wider economic impact of requiring a group to separate, as the PCBS recommended, any regulatory order to separate will also require approval from the Treasury. The Government will bring forward an amendment to the Bill to include the necessary provisions.[33]

30. The Government did not, however, accept the need for the second reserve power or for periodic, independent reviews of the ring-fence's effectiveness:

> Rather than helping to maintain the integrity of the ring-fence, this proposal appears to be based on the presumption that the ring-fence will prove to be ineffective in delivering the financial stability benefits it is intended to achieve. The Government does not accept that ring-fencing will fail, but agrees with Sir John Vickers and the ICB that ring-fencing will yield benefits to financial stability while preserving the

31 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 171

32 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 171

33 HM Treasury and Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, Cm 8545, February 2013, para 2.22

advantages that structured universal banking can bring. If in the future it became apparent that, due to developments in the nature of banking or other changes in circumstances, the ring-fence had become ineffective, then the Government would return to Parliament for a full debate on whether alternative structural changes were required. Given this, it is not necessary to legislate now for a reserve power to abandon ring-fencing at some point in the future. There would also be significant constitutional objections to a reserve power for the regulator to impose a radical change in the structure of the entire UK banking sector, and in effect to repeal most of the provisions of the Bill. In his evidence to the PCBS, Sir Mervyn King argued that such a 'sword of Damocles' should not be placed in the hands of regulators. The Government agrees that it is not appropriate to leave decisions over the fundamental structure of banking in the UK to the regulator: such decisions should be for the Government and Parliament, to ensure proper democratic accountability.[34]

The Second Report of the PCBS

31. Following the Government's response to its First Report, the PCBS published a Second Report which reiterated the case for the two reserve powers and set out its own proposed amendments to give effect to 'electrification' of the ring-fence. The amendments covered the first and second reserve powers and the independent review of the ring-fence.[35]

Passage of the Bill through the House of Commons

32. Although the Government had agreed in principle with many of the PCBS's recommendations on ring-fencing, the original amendments tabled by the Government at Report stage in the Commons fell well short of the PCBS's proposals, as the former Chairman of the PCBS, Andrew Tyrie MP, told the House on 8 July 2013:

> […] the Government's amendments would render the specific power of electrification virtually useless.
>
> […]
>
> [...] the Government accepted the case for ring-fencing, arguing that banks that test the ring fence should be strongly deterred and, if necessary, prevented from doing so. However, I am afraid that that will not be the effect of the Government's amendments. On the contrary, the Government amendments almost guarantee that banks will not get a shock, and will not be discouraged from testing or gaming the ring-fence. The regulator needs a useable and credible deterrent. This proposal creates too many obstacles and delays to the sanction of full separation.
>
> Frankly, it is inadequate for three main reasons. First, it requires the regulator to issue—we have already heard a little about this—no fewer than three preliminary notices and a warning notice before it can act. Secondly, it then requires the regulator to obtain permission from the Treasury no fewer than three times while the process

34 HM Treasury and Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, Cm 8545, February 2013, para 2.23

35 Parliamentary Commission on Banking Standards, Second Report of Session 2012–13, *Banking reform: towards the right structure*, HL Paper 126/HC 1012, Appendix

> is in train. Putting that requirement on the statute book would transfer most of the effective regulatory decision-making power away from the PRA and the Bank of England to the Treasury. It cannot be appropriate for the Treasury to be the regulator. The Commission argued for a Treasury override at the end of the process, not at the beginning or in the middle, but the Government's amendment requires the regulator to secure the consent of the Treasury on three occasions prior to that point. Even so-called preliminary notices—in effect, expressions of concern by the regulator—will require Treasury consent. That is absurd and compromises the regulator's independence.
>
> The third objection has also been alluded to. The Government's amendments allow at least five years for the completion of the separation after a decision has been made. That would create enormous scope—indeed, it would make it ideal—for lobbying for a change of heart in the interim. It would create far too much room for that and we can do without it. It also flies in the face of what the Minister said in Committee, where he alerted Parliament to the risk of what he described as an "inordinately long" delay in implementation. A tool that is so difficult and slow to use is likely to deter no one and that is why I have proposed a number of amendments that would remove some of the obstacles erected by the Government to taking action to separate banks.[36]

33. Opposition spokesman Chris Leslie MP also objected to the Government's amendments. His principal concerns were the numerous stages and notices involved in the separation procedure and the length of time that it would take for separation to take effect. He referred with approval to the PCBS's draft amendments on electrification. [37]

34. Greg Clark MP, then Financial Secretary to the Treasury, responded to Mr Tyrie that:

> [...] Our intention was—and is—to implement faithfully the Parliamentary Commission's recommendation on the institution-specific ring-fencing rule. As I assured [Mr Tyrie], I am confident that if the Government's proposals can be improved during the Bill's passage, all his concerns about the use of the power can be addressed. [38]

Amendments to the Bill introduced in the House of Lords

35. In response to the concerns raised by Commissioners in the House of Commons, Lord Deighton, Commercial Secretary to the Treasury, said during the Second Reading of the Bill in the House of Lords on 24 July 2013:

> [...] when [the electrification power] was debated in the Commons, questions were raised about the process for exercising it set out in the Government's amendment. Some argued that the procedure was too complicated or lengthy. The Government have listened to these arguments. We accept that the process for requiring a group to separate could usefully be streamlined. We will therefore bring forward amendments

36 HC Deb, 8 July 2013, col 75; 78–79 [Commons Chamber]

37 HC Deb, 8 July 2013, col 72–73 [Commons Chamber]

38 HC Deb, 8 July 2013, col 90 [Commons Chamber]

> to that effect while the Bill is before this House. And we will listen to the contributions of noble Lords to ensure that the process in the Bill meets the objectives that the PCBS set out, and which the Government share.[39]

Committee Stage

36. At Committee stage of the Bill in the House of Lords, the Government tabled a revised amendment in relation to the first reserve power to separate individual banking groups. It made the following changes:

- only one Preliminary Notice from the regulator would be required;
- Treasury consent would be required only once (in relation to the Warning Notice);
- the warning notice period was reduced from 6 months to a minimum of 3 months and maximum of 6 months;
- overall, the minimum period from preliminary notice to final notice was reduced to 4 months, roughly in line with the PCBS's own amendments, which stipulated a minimum period of 5 months from the first notice to the last; and
- the requirement to have a minimum of five years to complete a forced divestment or full separation ordered by the regulator was removed entirely and was replaced by regulatory discretion in relation to the deadline for completion.[40]

37. These amendments substantially addressed the recommendations of the PCBS. However, the Government continued to differ from the PCBS on the following points:

- There was no provision in relation to the first reserve power for an external reviewer to examine the relationship between the regulator and the banking group as a safeguard on the regulator's exercise of its power. The PCBS had recommended that such a review take place after the issuing of the preliminary notice. The Government, however, argued that the availability of a right of appeal to the Tribunal was the appropriate mechanism to safeguard against any abuse of power by the regulator.
- The Government did not accept the need for an independent review of the operation of the ring-fencing regime more generally. The PCBS considered such a review to be essential, on the grounds that such a radical re-design of the banking system ought to be independently reviewed. However, the review was also linked to other PCBS recommendations: a first review was to be carried out after four years and the regulator would not be able to use its first reserve power before this date; and recommendations contained in this or any subsequent reviews (at five year intervals) were to be the trigger for bringing into force the second reserve power.
- The Government continued to reject the need for a second reserve power to separate the banking sector as a whole. The Government argued that complete separation was a

39 HL Deb, 24 July 2013, col 1339 [Lords Chamber]

40 HM Treasury and Department for Business, Innovation and Skills, *Financial Services (Banking Reform) Bill Government Amendments: Group Restructuring Powers ('Electrification')—Briefing for Peers*, 1 October 2013, Annex A

different policy from that embodied in the Bill, that is, that ring-fencing was the appropriate mechanism for safeguarding against future failures in the banking system; that such a radical change to the banking system as a whole should properly be effected by primary legislation, affording opportunity for appropriate debate; and that any provision for full separation in the Bill would provide only for a binary option—full separation or not—and leave no opportunity to give effect to any third way recommended by an independent review.

38. Mr Tyrie issued the following press notice on the 1 October 2013, welcoming what was contained in the revised amendment:

> At the request of the Banking Commission the Government withdrew its original amendment on electrification of the ring fence for individual banks—'the specific powers'. It has now come forward with a major revision which largely reflects the Banking Commission's intentions. This is very welcome, the product of a number of helpful discussions with ministers.
>
> Banks will game the rules unless discouraged from doing so. The revised amendments enable the regulator to split a bank which tries. That creates a strong deterrent against gaming the ring fence.[41]

Report Stage and Third Reading

39. Following further pressure from former Commissioners, the Government accepted that an independent review should be set up to consider the operation of the ring-fence and that this review should be able to make recommendations, including a recommendation for full separation of retail from wholesale operations within the banking system. Lord Deighton stated that:

> To reflect that ring-fencing is a bold new step, the review's central task will be to assess how well the ring-fence is working. Its conclusions are not constrained; it can make any recommendations it sees as appropriate. If it believes that the ring-fence is in need of improvement or repair, it will be able to make recommendations as to what changes in the legislation or rules are required to fix it. Therefore I can give my noble friend Lord Lawson the unequivocal commitment which I think he asked for—I will test whether I have got this right—that if the review concludes that the ring-fence is irreparably broken, it will also have the scope to recommend an alternative approach altogether. That will, of course, include full separation.[42]

40. Under the new provisions, the review panel will be independent of the Treasury and of the regulators and the Treasury must consult the Chairman of the Treasury Committee of the House of Commons before appointing its members. As a result of a further Government amendment tabled at Third Reading, the review is to be held two years after the ring-fence comes into force. This means that the review will be in 2021, as ring fencing is to be introduced in 2019.[43]

41 "Banking Bill Back on the table", BBC News Politics, 2 October 2013

42 HL Deb, 26 November 2013, cols 1321–1322 [Lords Chamber]

43 Financial Services (Banking Reform) Act 2013, section 8

41. By the time the Bill completed its passage through Parliament, therefore, almost all of the major recommendations of the PCBS in relation to ring-fencing had been implemented. The only substantial matter outstanding was the second reserve power itself. However, the independent review of the ring-fence two years into its operation will be able, if it sees fit, to recommend changes that would give effect to full separation.

Other PCBS recommendations on ring-fencing, and developments since the passage of the Act

42. Following the passage of the Act, it fell to the Government to set out more details of the ring-fencing regime in secondary legislation, and to the regulator to implement it in practice.

43. The Government published its proposals for secondary legislation in June 2014. This clarified the definition of a "ring-fenced body" in the Act, as well as the scope of activities that ring-fenced bodies will be allowed to perform.[44] Among other things, the proposed secondary legislation:

- exempts from the definition of a ring-fenced body any banking groups which hold less than £25 billion in core deposits (to allow them to compete and grow without incurring disproportionate costs). The PCBS concluded in its first report that a 'de minimis' exception was "a sensible compromise between maintaining financial stability and encouraging new entrants to the banking industry".[45]

- allows organisations with a turnover of more than £6.5 million, more than 50 employees or a balance sheet total greater than £3.26 million, and high net-worth individuals with more than £250,000 of financial assets, to choose to bank outside the ring fence. The PCBS concluded in its first report that an exemption for large deposits "makes sense", and that it "is right that holders of large deposits should be required to make an informed decision to hold their deposits in a non-retail bank".[46]

- prohibits ring-fenced bodies from having exposures to other financial institutions outside their own corporate group, with a number of exceptions: they may have exposures for the purpose of managing their own risks; they may have exposures for the purpose of providing trade finance services; and they may have exposures arising from the provision of payments services to other financial institutions, subject to any requirements imposed by the regulator.

- prohibits ring-fenced bodies from establishing branches of subsidiaries outside the European Economic Area. In its first report, the PCBS said that it was "broadly content" with the Government's approach to geographic limits on the business of ring-fenced banks, but that consideration needed to be given to the effects on UK banks' ability to support trade. The PCBS therefore recommended that, when the relevant

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44 The draft Financial Services and Markets Act 2000 (Ring-fenced bodies and core activities) Order 2014 and the draft Financial Services and Markets Act 2000 (Excluded activities and prohibitions) Order 2014

45 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 200

46 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 203

secondary legislation came into force, the Treasury monitor and report to Parliament on its assessment of the trade-off between these two factors.[47]

- prevents ring-fenced bodies from dealing in commodities, in order to insulate them from swings in global commodity prices. This is in addition to the provision in the Act preventing them from dealing in investments as principal.

There are some exceptions to this last provision:

- Ring-fenced bodies will be allowed to sell a narrow range of simple derivatives to their customers, such as interest rate swaps and simple foreign exchange options. In its first report, the PCBS concluded that there was a case in principle for permitting the sale of simple derivatives within the ring-fence, but that this would need to be subject to conditions and safeguards.[48] Under the Government's proposals, ring-fenced banks' derivative folios will have caps on their size and riskiness, and the derivatives sold will be required to be traded in liquid markets and capable of valuation on the basis of observable market inputs.

- Ring-fenced bodies will be able to deal in investments as principal for the purpose of reducing their exposure to specified risks, including interest rate, currency and liquidity risk. This implements an ICB recommendation.

- Ring-fenced bodies will be allowed to trade with central banks.

44. On 6 October 2014, the PRA published proposals on the implementation of ring-fencing.[49] As part of these proposals, the PRA confirmed that it expected groups containing ring-fenced banks to adopt a 'sibling structure', in which ring-fenced and non-ring fenced banks must be subsidiaries of a UK holding company. This followed comments from Lord Deighton during Lords Committee stage of the Bill, that:

> I also expect the PRA to use [its rule-making power over group holding companies] to require groups containing ring-fenced banks to adopt a so-called "sibling structure". This means that a non-ring-fenced bank cannot own a ring-fenced bank and vice versa. Both the ring-fenced and the non-ring-fenced bank will sit directly underneath the holding company. In this way, the PRA will be able to supervise banking groups more effectively, by having a clear divide between the ring-fenced and non-ring-fenced parts of a group. As development of the ring-fencing policy has progressed, the PRA has identified additional supervision benefits to a "sibling" arrangement such as this. I also understand that the Bank of England is encouraging banking groups to issue loss-absorbing debt from the holding company level, which is likely to lower the marginal cost to banking groups from adopting the sibling structure.[50]

47 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 209

48 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 193

49 Prudential Regulation Authority consultation paper, *The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities*, CP19/14, October 2014

50 HL Deb, 8 October 2013, col 35 [Lords Chamber]

In turn, this followed the PCBS's recommendation in its first report:

> The Commission found that the arguments for prohibiting a non-ring-fence bank from directly owning a ring-fenced bank are persuasive. This is a clear and straightforward way to strengthen the ring-fence, and is far better done at the outset. The Commission recommends accordingly that the regulator be given the power to require a sibling structure between a ring-fenced and non-ring-fenced bank, with a holding company. The Commission would expect this power to be exercised.[51]

The PRA did not propose to make rules to this effect, but said it would "consider using its existing powers, as necessary […] to implement this policy".[52]

45. The Act requires the PRA to set out rules on the governance of ring-fenced bodies, designed to safeguard the core services they provide and their independence from other group entities. This provision followed a recommendation in the PCBS's first report that secondary legislation "should give the regulator a duty of ensuring operational independence for the ring-fenced bank in respect of governance, risk management, treasury management, human resourcing, capital and liquidity".[53] In its October 2014 consultation, the PRA accordingly proposed rules governing:

- The independence of ring-fenced bodies from other group entities generally, including the management of any conflicts of interest;
- The risk management and internal audit functions of ring-fenced bodies;
- The remuneration policies of ring-fenced bodies; and
- The HR policies of ring-fenced bodies.
- The composition of the boards of ring-fenced bodies.

46. The PRA also proposed rules on the continuity of services and facilities that ring-fenced bodies must have in place to perform their core functions. It will consult on further ring-fencing proposals—implementing, for example, the requirement to make rules restricting payments between ring-fenced bodies and other group members—in due course.[54]

Proprietary trading

47. The third report of the PCBS considered the prudential and cultural risks arising from 'proprietary trading'—in broad terms, trading where the bank is using its own funds, raised

51 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 228

52 Prudential Regulation Authority consultation paper, *The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities*, CP19/14, October 2014, p 10

53 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, para 224

54 Prudential Regulation Authority, *The implementation of ring fencing: consultation on legal structure, governance and the continuity of services and facilities*, CP19/14, October 2014, p 19

from shareholders, depositors and creditors, to speculate on markets without any connection to customer activity.

The PCBS's recommendations

48. The PCBS concluded:

> Proprietary trading gives rise to prudential risks. Concerns about the prudential risks from proprietary trading have been cited, not least by Paul Volcker himself, as one of the justifications for legislation to prohibit banks engaging in certain forms of proprietary trading in the USA. They are also the principal justification for proposed legislation to require partial separation for banking entities engaged in certain forms of proprietary trading in Germany and France. The Commission has concluded that the prudential risks associated with banks engaging in proprietary trading are not necessarily different in kind from those associated with a range of other banking activities, many of which made a greater contribution to the recent financial crisis. However, having greater exposure to markets than is necessary for client servicing increases the potential for risks that may not be fully understood until the next crisis.[55]

The PCBS was also concerned that proprietary trading could pose risks to the culture of a bank:

> The Commission is concerned that the conflict of interest which can arise from a bank attempting both to serve customers and trade its own position cannot be easily managed, and can be corrosive of trust in banking no matter what level of safeguards are put in place supposedly to separate these activities. The Commission is also concerned that the presence of proprietary trading within a bank, 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.[56]

49. Many of the leading UK banks told the PCBS in evidence that they were not currently engaged in proprietary trading, and a number of them agreed that proprietary trading was not a suitable activity in which customer-oriented banks should engage. However, the PCBS concluded that such reassurances alone could not provide a guarantee against the re-emergence of proprietary trading over time, "as public attention on banks' activities fades, economic circumstances change and another generation of bank leaders less scarred by recent events emerges".[57]

50. The PCBS therefore recommended that the PRA undertake immediate supervisory action, to hold banks to their assertion that they were not engaged in proprietary trading, and to bear down on it where necessary using existing tools such as capital add-ons. The PCBS further recommended:

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55 Parliamentary Commission on Banking Standards, Third Report of Session 2012–13, *Proprietary trading*, HL Paper 138/HC 1034, para 22

56 Parliamentary Commission on Banking Standards, Third Report of Session 2012–13, *Proprietary trading*, HL Paper 138/HC 1034, para 31

57 Parliamentary Commission on Banking Standards, Third Report of Session 2012–13, *Proprietary trading*, HL Paper 138/HC 1034, para 39

> As part of their commitment to enhanced disclosure, banks should be required to agree with the PRA a published statement of risk exposures in their trading book and of control issues in their trading operations raised by the PRA during the last year. Parliament will expect the PRA to report on these statements. It is possible that the PRA may not be able to justify use of existing tools in this way under its current mandate. We therefore further recommend that the Government consult the regulators on whether the current legislation needs amendment to give regulators the authority to carry out activities in pursuit of these regulatory aims.[58]

51. In addition to this immediate regulatory action, the PCBS recommended that the regulators carry out a report on proprietary trading within three years of the Act being passed. The report should include:

- analysis of the monitoring and corrective actions conducted in accordance with the recommendation for the PRA to monitor and bear down on proprietary trading;
- an assessment of any impediments encountered to such actions;
- the impact, by then, of the moves towards ring-fencing on banks' trading activities;
- lessons about the feasibility of defining and prohibiting proprietary trading within banks, based on the experience of other countries, in particular the USA, attempting to do this; and
- a full assessment of the case for and against a ban on proprietary trading.

The PCBS recommended that this report be presented to the Treasury and to Parliament upon completion, and that it serve as the basis of a further full and independent review of the case for action in relation to proprietary trading by banks. Legislation should be introduced to provide for such a review and to provide assurances about its independence, including a role for the House of Commons Treasury Committee in the appointment of the persons to carry out the review.[59]

Government's initial response

52. The Government responded to the PCBS's Report on proprietary trading on 8 July 2013. It agreed with the PCBS that the risks from proprietary trading could be considerable and should be properly controlled. However, the Government initially rejected the PCBS's recommendation of a regulatory report into proprietary trading:

> Given the limited evidence presented to both the Commission and the Independent Commission on banking (ICB) on the merits of a ban on proprietary trading the Government does not at this stage intend to ask the PRA to carry out such a report. The regulator already has extensive reporting requirements which it will be expected to use to highlight emerging risks, including those from proprietary trading. The Government will follow closely the way in which other countries are able to

58 Parliamentary Commission on Banking Standards, Third Report of Session 2012–13, *Proprietary trading*, HL Paper 138/HC 1034, para 97

59 Parliamentary Commission on Banking Standards, Third Report of Session 2012–13, *Proprietary trading*, HL Paper 138/HC 1034, para 98

> implement bans on proprietary trading and will regularly confer with the regulator to learn more about the level of suspected proprietary trading throughout the financial system.[60]

It did not respond to the PCBS's proposal for an independent review.

Legislative change

53. During Lords Report Stage, Lord Lawson of Blaby tabled an amendment to PCBS's recommendations, requiring the regulators to conduct a review of proprietary trading, and requiring the Treasury to arrange for an independent review on receipt of this.

54. Lord Deighton, speaking for the Government, accepted the spirit of the amendment, saying:

> [W]hile the regulators are currently equipped to deal with risks if and when they arise, it seems only reasonable that these arrangements should be reviewed over time and that we should take a strategic look at what any future risks from proprietary trading might mean for the UK banking sector as a whole, including whether the regulators' powers are appropriate.
>
> I believe that the approach recommended by the PCBS on this is the right one. First, it should be for the PRA and FCA to review the situation, assess their powers and recommend further action to the Government. However, it also seems right that we review this matter once ring-fencing is in place and its effects have been analysed. It would therefore make sense for any such review to incorporate the thinking from the wider review into the ring-fence.
>
> Therefore, I propose to noble Lords that the Government commit to a review of proprietary trading if the PRA deems it necessary, having evaluated its powers and practices in this area. The Treasury will therefore ask the PRA whether it feels equipped to deal with any risks from proprietary trading that may have arisen by that time. If the PRA does not think that it has the right tools, the Treasury will conduct a review of proprietary trading and its impacts, including on ring-fenced banks. That review of course will consider further safeguards against potential future risks from proprietary trading, including a ban, should it conclude that such safeguards are necessary.
>
> Any review that does its job will also consider the experience that other countries have had with structural reforms. The Volcker rule in the US would of course be an obvious candidate, as my noble friend Lord Lawson said. […]
>
> It is reasonable to suggest that ring-fencing should be in place before such a review takes place. I suggest that it should take place only after ring-fencing has been in place for at least a year, and possibly should coincide with the wider review into the operation of the ring-fence. The evidence base will then be much richer.[61]

60 HM Treasury and the Department for Business, Innovation and Skills, *The Government's Response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, p 76

61 HL Deb, 27 November 2013, cols 1471–1472 [Lords Chamber]

Lord Deighton undertook to return at Third Reading with a proposal to this effect. Lord Lawson therefore withdrew the amendment, noting:

> I am grateful that my noble friend said that he would come forward with something at Third Reading. That something will have to be not the possibility of a review but a clear commitment to a review. I think that it is a separate matter from the ring-fence. The ring-fence is about a division of banking; this is a ban.[62]

55. At Third Reading, the Government tabled an amendment to the Bill that required the PRA to conduct a review of proprietary trading, to begin within twelve months of ring-fencing coming into effect. This review would consider:

- the extent to which banks engaged in proprietary trading;
- whether proprietary trading engaged in by banks gave rise to any risks to their safety and soundness;
- whether any kinds of proprietary trading were particularly likely to give rise to such risks;
- anything done by the PRA to minimise risks to the safety and soundness of banks arising from proprietary trading engaged in by them; and
- any difficulties encountered by the PRA in seeking to minimise such risks.

The review would also include an assessment by the PRA of:

- whether the PRA's powers under FSMA 2000 are, and might be expected to continue to be, sufficient to enable it to advance its objectives in relation to banks who engage in proprietary trading; and
- the effectiveness of restrictions imposed in countries or territories outside the United Kingdom on proprietary trading by banks.

56. The Government also tabled an amendment at Third Reading requiring an independent review of proprietary trading based on the PRA's report. This would commence within two years of ring-fencing coming into force, and report within "a reasonable time". The final report would:

- state whether the panel agrees with the conclusions reached by the PRA in its report;
- state whether the panel recommends any further restrictions on any kind of proprietary trading in relation to banks; and
- make such other recommendations as the panel thinks fit.

62 HL Deb, 27 November 2013, col 1472 [Lords Chamber]

5 Strengthening individual accountability

Background: the Approved Persons Regime

57. Under the conduct regime that has existed hitherto, regulators have had the power to require certain individuals within banks to seek pre-approval from the regulator before taking up their positions. Such individuals have been known as "Approved Persons" and the arrangements under which they have been approved are referred to as the Approved Persons Regime (APR).

58. The framework can be summarised as follows:

- the regulators specify certain functions as "controlled functions";
- the bank concerned applies to the regulators for approval for a named individual to carry out a particular controlled function or functions;
- the regulators decide whether to grant the approval based on consideration of whether the candidate is "a fit and proper person" to perform the function to which the application relates, subject to a right of appeal;
- the regulators may withdraw approval of a person as "fit and proper", subject to appeal, and impose penalties on individuals who carry out controlled functions without approval; and
- the regulators can issue statements of principle relating to the conduct expected of persons approved to carry out controlled functions ("Approved Persons").

59. Under FSMA 2000, the controlled functions that require individuals to become Approved Persons can be of two types:

- a "significant-influence function" (SIF), which means a function "that is likely to enable the person responsible for its performance to exercise a significant influence on the conduct" of the affairs of the authorised entity; and
- a "customer-dealing function", which means a function that will involve the person performing it in dealing with the bank's customers or the property of the bank's customers "in a manner substantially connected with the carrying on of a regulated activity".

60. Where a bank identifies that a person is to undertake a function or functions bringing them within the APR, they make an application to the regulator. The regulators have regard to a number of criteria when assessing the fitness and properness of Approved Persons, the most important of which are:

i. honesty, integrity and reputation,

ii. competence and capability, and

iii. financial soundness.

Once approved, an Approved Person is subject to the regulatory Statements of Principle for Approved Persons and accompanying code of conduct which, together, establish standards of conduct.

The existing system of registration

61. The Financial Services Register is maintained by the FCA under section 347 of FSMA 2000. This is, essentially, a record of information about financial services firms but the register must also include information about Approved Persons and individuals who have been banned from the industry by a prohibition order made under section 56 of FSMA.

62. Section 347 also sets out the minimum information the register must contain about firms or individuals on it. For Approved Persons, the register must include the person's name, the name of the firm in which the Approved Person works and (if relevant) the name of the contractor who employs the Approved Person.

The PCBS's Recommendations

63. The APR was the primary framework for regulators to engage with individual bankers. The PCBS considered that the APR was "a complex and confused mess", and concluded that:

- it failed to perform its various functions to the necessary standard;
- as the mechanism through which individuals could notionally be sanctioned for poor behaviour, its coverage was too narrow and it did not ensure that individual responsibilities were adequately defined, restricting regulators' ability to take enforcement action;
- although in principle it was the means by which the regulator could control those who ran banks, in practice it made no attempt to set clear expectations for those holding key roles, operating 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.[63]

64. In view of its shortcomings, the PCBS recommended "three main pillars of a new system to replace the Approved Persons Regime". These were:

- a Senior Persons Regime, to replace the Significant Influence Function element of the Approved Persons Regime;
- a licensing regime to include anyone working in banking whose actions could cause serious harm to their bank, its reputation or its customers, which would replace the Approved Persons Regime as the basis for upholding individuals' standards of behaviour. This would be founded on a new set of banking standards rules of wider applicability; and

63 Parliamentary Commission on Banking Standards, *Changing banking for good*, Session 2013–14, HL Paper 27/HC 175, para 564

- reform of registration to support the first two pillars and provide a record of and access to, amongst other things, disciplinary information.[64]

The Senior Persons Regime

65. The PCBS intended that the Senior Persons Regime should apply to banks operating in the UK and that it should provide assurance that key responsibilities within banks were assigned to specific individuals who were aware of those responsibilities and had formally accepted them.[65] The PCBS expected that the Senior Persons Regime would cover a narrower range of individuals than those currently engaged in Significant Influence Functions, as many of the people in performing those functions were not, in reality, senior decision-takers. Taking such people outside the scope of the Senior Persons Regime (although most would still be subject to the proposed Licensing Regime—see paragraphs 68–70 below) would allow the Senior Persons Regime to be focused much more clearly on those in real positions of authority within a bank who should stand or fall by the quality of their decision-making. The PCBS considered that board and executive committee members should always be within the scope of the Senior Persons Regime. That aside, in the first instance banks themselves should take primary responsibility for identifying which individuals should fall within the Senior Persons Regime and for defining their responsibilities. The PCBS thought that it should not be for the regulator to prescribe how banks structure their management, because it was important that banks retain the flexibility to do this in the most appropriate way for their business.[66]

66. As a framework for the system, the PCBS recommended that regulators set out in guidelines how responsibilities were to be identified and assigned, and should have the power to take enforcement action against firms. In particular, the PCBS recommended that:

- all key activities that the business undertook or key risks to which it was potentially exposed should be assigned to a Senior Person;
- 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;
- individuals should be fit and proper to carry out responsibilities assigned to them, and be able to demonstrate the necessary skills and experience;
- responsibilities should be shared only where they are generic to the office, such as a non-executive member of the board; otherwise, they should be specific to an individual;
- a Senior Person should not report directly to anyone within a UK-based organisation who is not themselves a Senior Person; and

64 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 612

65 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 616

66 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 617

- a bank's board should have a duty regularly to certify to the regulator that their firm was fulfilling its obligations under the Senior Persons Regime.[67]

67. The PCBS made a series of recommendations to restore individual responsibility. It considered that the regulators should be empowered to review the assignment of responsibilities to a particular individual and to require the redistribution of certain responsibilities or the addition of certain conditions. Further, the regulators should be able to make approval of an individual Senior Person subject to conditions.[68] The PCBS stated that it should be a requirement of those in the Senior Persons Regime that, before relinquishing any responsibilities to a successor, they prepare a handover certificate outlining how they have exercised their responsibilities and identifying relevant issues of which the successor should be aware. Such handover certificates should be held by banks as a matter of record and be made available to the regulators both to assess the effectiveness of the Senior Persons Regime within a particular bank and to assist with the attribution of responsibility in the event of subsequent enforcement action.[69]

The Licensing Regime

68. The second pillar of the new system recommended by the PCBS involved the establishment of a Licensing Regime alongside the Senior Persons Regime. Under the new Licensing Regime, a broader set of bank staff would be contractually obliged to adhere to a set of Banking Standards Rules, enforceable by the regulators, to replace the existing Statements of Principle.[70] These rules would form the foundation of individuals' understanding for how they were expected to behave: the rules should, the PCBS said, be written in a way which was readily meaningful for those who must adhere to them. The PCBS proposed that the rules should apply both to Senior Persons and licensed individuals.

69. The PCBS recommended that the Licensing Regime apply to anyone working in banking, including those already within the Senior Persons Regime, "whose actions or behaviour could seriously harm the bank, its reputation or its customers". It was not intended to cover staff working in auxiliary or purely administrative roles, or those in junior positions whose autonomy and responsibility was very limited.[71]

70. Licensing would involve employers verifying the fitness and propriety of staff, including checking the register for any record of past disciplinary action, and would not require pre-approval by the regulators. Banks would be responsible for ensuring that staff understood their responsibilities and the Banking Standards Rules applicable to them and for taking disciplinary action under an employee's contract of employment when standards

67 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 618

68 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 626

69 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 627

70 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 632

71 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 633

were breached. The banks would be required to keep accurate records of their staff, their responsibilities and any disciplinary action taken. The regulators would have discretionary power to require those leaving certain posts to prepare handover certificates, in line with a similar duty under the Senior Persons Regime. The PCBS expected that a particular Senior Person should be directly responsible for the performance by a bank of its licensing responsibilities and that the regulators should be able to take enforcement action against the banks if they were found to be failing in their duties in relation to the Licensing Regime.[72]

Reforming the register

71. The third and final pillar of the PCBS's conduct regime involved reform of the register underpinning the current APR to take account of the PCBS's recommendations. A single register should cover both the Senior Persons Regime and the Licensing Regime, although for individuals covered only by the Licensing Regime it was thought likely to be more proportionate only to include their details where there had been enforcement action against them. Banks should be required to inform regulators if they take disciplinary action against an employee for reasons related to a breach of the Banking Standards Rules. In such cases, regulators should assess whether any further sanction was merited. Regulators should be able to retain such information for their own purposes even where they decide not to proceed with enforcement action.[73]

Stronger sanctions on senior individuals

72. The PCBS concluded that stronger sanctions on senior individuals were necessary to set the right incentives in banking:

> Faced with the most widespread and damaging failure of the banking industry in the UK's modern history, the regulatory authorities seemed almost powerless to bring sanctions against those who presided over massive failures within banks. Public concern about this apparent powerlessness is both understandable and justified, but the need for a more effective enforcement regime does and should not arise from a public demand for retribution. It is needed to correct the unbalanced incentives that pervade banking. These unbalanced incentives have contributed greatly to poor standards. Redress of these is needed not merely as a step to restoring public confidence, but also to create a new incentive for bankers to do the right thing, and particularly for those in the most senior positions fully to fulfil their duties and to supervise the actions of those below them.[74]

The PCBS made recommendations in respect of both criminal and civil enforcement.

72 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, paras 642 and 643

73 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 651

74 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 234

A new criminal offence

73. The PCBS proposed that a new criminal offence of reckless misconduct in the management of a bank be introduced. The PCBS set a high bar for the application of the criminal sanction—'reckless' mismanagement itself provided a high hurdle, and in addition the offence would apply only in cases of firm failure. Its scope would be limited to individuals who were both responsible for managing a bank and part of the Senior Persons Regime. The PCBS noted:

> The Commission has concluded that there is a strong case in principle for a new criminal offence of reckless misconduct in the management of a bank. While all concerned should be under no illusions about the difficulties of securing a conviction for such a new offence, the fact that recklessness in carrying out professional responsibilities carries a risk of a criminal conviction and a prison sentence would give pause for thought to the senior officers of UK banks. The Commission recommends that the offence be limited to individuals covered by the new Senior Persons Regime, so that those concerned could have no doubts about their potential criminal liability.
>
> The Commission would expect this offence to 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 credibility of such an offence would also depend on it being used only in the most serious cases, and not predominantly against smaller operators where proving responsibility is easier, but the harm is much lower. Little purpose would be served by the creation of a criminal offence if the only punishment available to the courts were the imposition of a fine, because substantial fines can already be levied as a civil sanction with a lower burden of proof. We would expect the determination of the available sentences to have regard to relevant comparable offences.[75]

Reversal of the burden of proof in respect of civil sanctions

74. The PCBS also concluded that, although a range of civil sanctions were already available to the regulator, these had not been successfully applied in the most important cases. It therefore refrained from proposing new civil sanctions, but determined that there was a case for shifting the burden of proof from the regulator onto the individual in cases of civil misconduct, in certain, well-defined circumstances:

> Greater individual accountability needs to be built into the FCA's and PRA's processes. The Commission recommends that legislation be introduced to provide that, when certain conditions are met, the regulators should be able to impose the full range of civil sanctions, including a ban, on an individual unless that person can demonstrate that he or she took all reasonable steps to prevent or mitigate the effects of a specified failing. The first condition would be that the bank for whom the individual worked or is working has been the subject of successful enforcement

75 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 243

> action which has been settled or upheld by tribunal. The second condition is that the regulator can demonstrate that the individual held responsibilities assigned in the Senior Persons Regime which are directly relevant to the subject of the enforcement action.[76]

Implementation of the PCBS's recommendations

75. The Government undertook in its response to the PCBS published on 8 July 2013 that it would introduce a Senior Persons Regime to replace the APR, introduce a criminal offence of reckless misconduct in the management of a bank, and reverse the burden of proof for Senior Persons in certain cases of civil miscondcuct.[77] The Government also said it would take forward the PCBS's recommendation to replace the existing statements of principle for Approved Persons with banking standards rules, although it gave no other assurances on implementing the Licensing Regime. The Government's proposals were not ready in time for the Commons Report stage of the Bill which took place on the same day. Mr Tyrie said on that occasion:

> We have been heartened by the initial reception to our final report, as with our previous reports. The big test now lies with the other place to amend the legislation to incorporate our proposals. We have been denied effective scrutiny in the Commons by the Government's insistence on abiding by what amounts to an arbitrary timetable and a rushed end date. Since we have already been hit by the full effects of the crisis, the rush is inexplicable. With a few extra months, the Bill could be immeasurably improved.[78]

By the time the Bill had passed through the House of Lords, the PCBS's recommendations had, indeed, been implemented, but the process took some time and the details were still being developed up until Third Reading.

Amendments introduced by the Government in the House of Lords

76. Initially, the Government tabled amendments at Committee stage which eventually formed part of what is now Part 4 of the Act, entitled "Conduct of persons working in financial services sector". At this stage, the Government was addressing only the recommendations forming the first pillar of the PCBS's scheme, that is, its proposals for a Senior Persons Regime.

Conduct of Senior Managers

77. The amendments provided for the regulators to set out in rules which senior management functions would require regulatory approval for the person carrying them out. A "senior management function" was defined as involving managing an aspect of the affairs of a firm where those aspects could involve serious consequences for the firm or for

76 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 240

77 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, para 2.13

78 HC Deb, 8 July 2013, col 81 [Commons Chamber]

wider business or other interests in the UK. Regulators also had to consider whether a person had responsibility for aspects of a firm's business that gave rise to key risks. The Government considered that this addressed the PCBS's recommendation that the Senior Persons Regime (now called in the Act the 'Senior Managers Regime') should focus on those with real responsibility for management and key risks; and risks not just to the bank but to the whole country.[79]

78. The definition of senior management functions is of general application, but a person must qualify as a senior manager in relation to a "bank" in order for the new regime for senior managers and banking standards to apply. The definition of "bank" became a significant issue as the Bill progressed through the House of Lords, and this is explored in more detail below (see paragraphs 91–93).

79. Much as with the APR, the bank is responsible for making the application for approval of an individual in relation to a senior management function. As part of this application, the firm must now submit a statement of responsibilities. A significant change in responsibility post-approval will require submission of an updated statement of responsibilities to the regulator, and a new role for the approved person would require a new application and a new statement of responsibility.

80. The statement of responsibilities is consistent with the PCBS's wish to ensure that key responsibilities are assigned to specific individuals who are aware of those responsibilities and have formally accepted them.[80] The recommendations that senior persons should only report directly to other senior persons, and that banks' boards should certify regularly to the regulator that they are fulfilling their obligations under the Senior Persons Regime, were not addressed by the Government's amendments at Lords Committee stage.[81]

81. Under the Government's scheme, in response to an application for an individual to perform a designated senior management function, the regulator may, in accordance with published policies:

- approve the candidate as a "fit and proper person";
- approve the candidate on a conditional basis or subject to time limits (this requires a procedure involving warning and decision notices and a right of appeal to the Tribunal); or
- reject the candidate.

Conditions of approval may be varied on application by the bank, in which case the regulator must make a decision within three months and issue a warning notice before any refusal. Approval may also be varied by the regulator at its own initiative, whether the original approval was conditional or unconditional. The FCA may vary PRA approvals and vice versa. The regulator may impose, vary or remove conditions or add time limits, with

79 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 612

80 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 616

81 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 618

immediate effect if necessary. These provisions are consistent with the PCBS's recommendations.[82]

Licensing/Certification

82. The former Commissioners maintained the pressure on the Government to introduce a licensing regime throughout the remaining stages of the Bill in the House of Lords. It was not until Third Reading that the Government finally produced a series of amendments which more fully implemented the PCBS's recommendations. On behalf of the Government, Lord Newby said on the floor of the House:

> My Lords, these amendments do two things. First, and most obviously, they implement the changes that have been agreed with members of the Parliamentary Commission on Banking Standards to implement the Commission's recommendations for a licensing regime.
>
> The Government's amendments in Committee put in place the key element of those recommendations, the pivot on which the Commission's concept of a licensing regime rests, giving the regulators the ability to make rules for employees who were not senior managers, but Commission members were concerned that the Government's amendments did not give sufficient visibility or, as I put it, "full weight and impetus", to the Commission's proposals and we undertook to bring forward amendments at this stage which will, as I said in Committee, "put beyond doubt the determination which we all share to see real change in this area".[83]

83. In summary, the Government amendments require banks to certify their staff on an annual basis and enforce banking standards. The certification process will apply to employees engaged in "significant-harm functions", meaning that aspects of their activity involve, or might involve, a risk of significant harm to the bank or any of its customers; and banks must verify that their staff are fit and proper for these functions. The documents issued to confirm "fit and proper" status are referred to as certificates rather than licences, and so the system is referred to as the 'Certification' regime. Banks will be required to keep records of those issued with certificates. Moreover, they will be required to notify the regulators of any formal disciplinary action taken against all bank staff, and not just senior managers and certificate-holders.

84. In relation to the PCBS's recommendations on employee education and awareness, the Government's amendments require banks to notify staff of the banking standards rules which apply to them and to ensure that they understand their obligations. This will involve providing suitable training for staff.

85. Former PCBS Members in the Lords welcomed these amendments. Lord Turnbull said:

> My Lords, the PCBS always envisaged a two-tier system, one for senior persons where prior registration would be required, and the other for staff below that who are not senior persons but who are nevertheless capable of inflicting damage to the bank,

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82 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 626

83 HL Deb, 9 December 2013, col 670 [Lords Chamber]

> its customers or its shareholders. We felt that the original provisions made for the upper tier were broadly okay [...] However, we thought that the provision made for the second tier was too vague. I therefore welcome these amendments, which bring much greater focus to who is covered and what the obligations are.[84]

The Register

86. In relation to the PCBS's third pillar of its conduct regime, reform of the register, the Government introduced an amendment requiring the FCA to record on the register whether an approved person working in a bank is a senior manager, thus identifying the person as someone to whom the new conduct rules apply. The register must also record whether a senior manager has been sent a final notice in relation to a conduct issue or in certain circumstances connected with conditions imposed upon approval, together with information about the matter to which the final notice relates. This means that successful enforcement action will now be entered on the register for senior managers performing senior management functions.

Conclusion: action on the three pillars

87. The Financial Services (Banking Reform) Act therefore broadly implements the PCBS's recommendations for the three pillars of a new conduct regime. Mr Tyrie said:

> The Banking Commission's proposals do not guarantee better standards. Much will depend on the judgment of regulators and the common sense of the banks, but identifying responsibility for key roles offers a much better prospect of higher standards than does retaining the APR. The Commissioners are delighted that our proposals on this are now going to be put on the statute book.[85]

Mr Tyrie did note, however, that the APR would continue to apply to many in financial services outside mainstream banking, including those working in fund management and insurance:

> Everyone now seems to be agreed that the APR adds little or nothing, yet over the past few weeks we have discovered that the discredited APR will survive in legislation. In doing that, the regulators are perpetuating a myth that the APR affords any real protection. It will continue to apply to several groups. First, about 20,000 people in the financial services industry outside banking will still be covered, mainly in fund management and insurance.
>
> This is unfinished business. The Banking Commission had the remit to look only at banking. It would be absurd to retain a system for one part of financial services that has so clearly failed in another. The Government and Parliament both need to encourage the regulator to look at this and do what is necessary to extend the coverage of the new regime and to remove the APR from other parts of financial services. To rely on the APR is asking for trouble.[86]

84 HL Deb, 9 December 2013, col 672 [Lords Chamber]

85 HC Deb, 11 December 2013, col 267 [Commons Chamber]

86 *Ibid*.

Criminal sanction

88. The Government legislated to introduce a new criminal sanction, as recommended. This sanction would apply only if an individual took or allowed a decision that led to the failure of their firm, knowing at the time that firm failure was a risk of the decision, and exhibiting conduct in relation to the taking of the decision which "falls far below what could reasonably be expected" of them.

89. The PCBS had recommended that the sanction apply only to those who commit reckless misconduct in the management of a bank—that is, only to those who actually manage a bank—so long as they are also in the Senior Persons Regime. However, the Government instead made all individuals in the Senior Managers Regime subject to the criminal sanction. Depending on the scope of the SMR decided on by the regulators, this could potentially bring all non-executive directors of a bank within scope of the measure.

Reversal of the burden of proof in cases of civil misconduct

90. The Government also legislated to reverse the burden of proof for individuals in certain cases of civil misconduct. This measure, which applies only to Senior Managers, ensures that an individual will be presumed responsible for any regulatory breach in his or her area of responsibility, unless he/she can demonstrate that he/she had taken such steps as he/she could "reasonably be expected" to take to prevent the breach from occurring.

Definition of 'bank'

91. The Government originally failed to provide an adequate definition of a bank. The PCBS's recommendations on conduct were intended to apply to all banks. However, during the course of debate on the conduct provisions in the House of Lords, it became apparent that the application of the proposed new conduct regime was restricted to deposit-taking institutions. While this would, indeed, cover many banking institutions, it would not necessarily cover those institutions generally called "investment banks". The former Commissioners considered this a serious defect in the legislation and called for it to be rectified. The former Commissioner Lord Turnbull said in Committee:

> [...] serious issues are left unresolved. Amendment 55 provides a definition of a bank to which the regime applies. I found it impossible for discover what the definition means. Does it meet the Commission's objective of covering all banks and holding companies operating in the UK? Would the Minister clarify what he means by "bank"? Could it be a ring-fenced bank, a non-ring-fenced entity conducting investment activities within a group, a whole group or a freestanding investment bank? In our view, the new senior managers regime should apply to all such entities. It would make a mockery of the scheme if, as I suspect may be the case, it applied only to banks taking deposits from the general public—that is, ring-fenced banks. It would be completely unacceptable if the regime did not apply, for example, to the senior managers overseeing the LIBOR traders, to those overseeing rogue traders such as the "London Whale", to those overseeing the marketing of highly dubious

> packages of sliced and diced mortgages or to those engaged in the mis-selling of interest rate swaps.[87]

92. In response, the Government introduced the concept of a "relevant authorised person" as the relevant banking entity for the purposes of the conduct provisions. This definition includes UK institutions which are either deposit-taking institutions or investment firms which are regulated by the PRA in relation to the activity of dealing in investments as principal. This means that investment banks significant to UK financial stability are now covered by the new conduct provisions. The episode demonstrates the benefits of the careful scrutiny of this legislation by the former members of the PCBS.

93. In addition, at Third Reading in the House of Lords, the Government introduced an amendment to empower the Treasury to extend the conduct provisions to branches of foreign banks operating within UK jurisdiction. As Lord Newby said on behalf of the Government:

> Branches of foreign banks and investment firms operate in London. Often international banks will have both branches and subsidiaries. A branch is not a separate legal entity unlike a subsidiary company. However, it is likely that there will be staff working in branches in the UK who should be covered by the senior managers regime or the certification regime and so be subject to banking standards rules. Amendments 17 and 18 therefore give the Treasury the power to extend the senior managers, certification and banking standards regime to the UK branches of foreign banks and investment firms by order, after undertaking appropriate consultation. This will mean that branches and subsidiaries can be treated identically.[88]

In June 2014, the Chancellor announced that he intended to exercise this power, and extend the new regimes to branches of non-EEA banks operating in the UK. The Treasury is set to consult on this proposal later this year.[89] This is essentially in line with the PCBS's recommendation that the conduct provisions applying to senior managers should apply to all banks operating in the UK, although the Government's amendment also applies to certification.[90]

Regulators' consultations

94. In July 2014, the PRA and the FCA published consultations on the detailed implementation of the new regimes. Some of the key features proposed were as follows.

Senior Managers Regime

95. The PRA and the FCA set out the roles within banks that they intended to capture in the Senior Managers Regime. The PRA intends to include a handful of key executives and

87 HL Deb, 15 October 2013, col 389

88 HL Deb, 9 December 2013, cols 671–672

89 Financial Conduct Authority and Prudential Regulation Authority joint consultation paper, *Strengthening accountability in banking: a new regulatory framework for individuals*, FCA CP14/13, PRA CP14/14, July 2014, p 46

90 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 617

non-executives, while the FCA intends to include all members of a bank's board. The FCA also intends to include 'Significant Responsibility Senior Managers'—individuals with responsibility for certain 'key functions' specified by the FCA (for example, retail lending decisions, or mortgage advice) where these individuals do not already hold other positions in the SMR. See Table 1 for the full scope proposed by both regulators.

Table 1 – Senior Managers Regime roles proposed by the regulators

PRA	**FCA**
Chief Executive function	Executive Directors
Chief Finance function	Non-Executive Directors
Chief Risk function	Chair of Nominations Committee
Head of Internal Audit	Money Laundering Reporting Officer
Heads of key business area (individuals managing a business area or division so large in relative terms to the size of the firm that it could jeopardise its safety and soundness)	Compliance Oversight Officer
Chairman	Significant Responsibility Senior Managers
Chair of the Risk Committee	
Chair of the Audit Committee	
Chair of the Remuneration Committee	
Senior Independent Director	
Group Entity Senior Managers (individuals in group or parent companies exercising significant influence on a firm's decision-making)	
Credit Union Senior Manager (for small credit unions only)	

96. The regulators also set out proposals for allocating responsibilities to Senior Managers. The PRA proposed a set of twenty 'Prescribed Responsibilities'—including, for example, the management of the allocation and maintenance of capital, funding and liquidity, and the protection of whistleblowers—which firms would be required to allocate to individuals in the SMR. Firms would also be able to identify and allocate responsibilities of their own. The FCA proposed to adopt the PRA's 'Prescribed Responsibilities', and, as described above, specified further 'key functions' which should be allocated to individuals. The FCA also proposed that firms should allocate responsibilities for other key risks and business activities identified in various parts of its regulatory 'Handbook'.[91]

91 Financial Conduct Authority and Prudential Regulation Authority joint consultation paper, *Strengthening accountability in banking: a new regulatory framework for individuals*, FCA CP14/13/PRA CP14/14, July 2014, p 17

97. The regulators set out some guidelines for the allocation of responsibilities to individuals. These did not, however, address all of the areas that the PCBS recommended. For example, the regulators did not make clear that the assignment of formal responsibilities should be aligned with the realities of power and influence within a bank. Little guidance was provided on how firms should identify and allocate responsibilities themselves; the PRA noted, however, that additional responsibilities drawn up by firms "must not modify or qualify any responsibilities prescribed by the PRA".[92]

Certification Regime

98. The regulators set out a proposed scope for the Certification Regime. As previously described, the Act requires the regulator to specify which roles may involve a risk of significant harm to firms or its customers. Such roles will fall within the regime.

99. The PRA determined that, for prudential purposes, the set of individuals that could cause serious harm to the firm was broadly the same as the set of individuals whose actions could have a material impact on the risk profile of the firm—that is, 'material risk takers', as defined by EU regulations.[93] The PRA therefore proposed to align its definition of certified persons broadly with that of 'material risk takers', with some exceptions.[94]

100. The FCA proposed to adopt the PRA's proposed scope for its Certification Regime, with some additions:

- 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 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.

Conduct Rules

101. The regulators also produced a set of proposed 'Conduct Rules', following the PCBS's call for a set of 'Banking Standards Rules' that would apply more widely than the existing Statement of Principles for Approved Persons. As described, the PCBS proposed that the rules should apply to both Senior Managers and certified staff, and that they should form the foundation of their understanding for how they were expected to behave. The rules, the PCBS said, should be written in a way which was readily meaningful for those who must adhere to them.

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92 Financial Conduct Authority and Prudential Regulation Authority joint consultation paper, *Strengthening accountability in banking: a new regulatory framework for individuals*, FCA CP14/13, PRA CP14/14, July 2014, p 17

93 The Capital Requirements Directive as supplemented by Commission Delegated Regulation (EU) No 604/2014

94 'Material risk takers' that qualify for the SMR will fall under the SMR and not the Certification Regime. Some material risk takers may also fall outside the statutory definition of 'significant harm function', for example if they work for an overseas subsidiary of a UK firm and therefore have no involvement in the "regulated affairs" of the UK firm (a condition for inclusion in the Certification Regime).

102. The PRA proposed that its rules should apply only to individuals in the Senior Managers and/or Certification Regimes. The FCA, however, proposed that certain of its rules should apply to all employees of a bank except for 'ancillary' staff—those individuals whose role would be fundamentally the same as it would be if they worked in a non-financial services firm. Such staff would include receptionists, security guards and cleaners.

103. The full set of rules proposed by the regulators, and the coverage that each regulator proposed for those rules, is set out in Table 2.

Table 2 – Conduct Rules proposed by the regulators

	Rule	Which regulator?	Applicable to which individuals?
1	You must act with integrity	PRA	Senior Managers and Certified staff
		FCA	All but 'ancillary' staff
2	You must act with due skill, care and diligence	PRA	Senior Managers and Certified staff
		FCA	All but 'ancillary' staff
3	You must be open and cooperative with the FCA, the PRA and other regulators	PRA	Senior Managers and Certified staff
		FCA	All but 'ancillary' staff
4	You must pay due regard to the interests of customers and treat them fairly	FCA	All but 'ancillary' staff
5	You must observe proper standards of market conduct	FCA	All but 'ancillary' staff
6	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively	PRA	Senior Managers
		FCA	Senior Managers
7	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system	PRA	Senior Managers
		FCA	Senior Managers
8	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively	PRA	Senior Managers
		FCA	Senior Managers
9	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice	PRA	Senior Managers
		FCA	Senior Managers

6 Non-legislative implementation of PCBS recommendations

104. A number of the most significant recommendations of the PCBS have been implemented other than through legislation.

Leverage ratio

105. The first Report of the PCBS concluded that:

> Reliance on capital requirements based on risk weighted assets alone is not sufficient. The leverage ratio is an important part of banks' minimum capital requirements.
>
> […]
>
> We believe that high leverage was a significant contributor to the crisis. The Commission considers it essential that the ring-fence should be supported by a higher leverage ratio, and would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III.
>
> […]
>
> The FPC should be given the duty of setting the leverage ratio from Spring 2013.
>
> […]
>
> The Commission recommends that the new Bill require the Bank of England to provide an annual assessment to be laid before Parliament of progress of risk-weighting and that the assessment should examine in particular the possible operation of floors for risk-weights, and steps taken with regard to simplification of risk-weights and trading exposures.[95]

106. The Government initially rejected these proposals:

> The Government strongly supports the introduction of a minimum leverage ratio as a backstop to risk-weighted capital requirements, as recommended in the Basel III Accord. The Government continues to press for full implementation of Basel III through European legislation. As the PCBS has recognised, a leverage ratio that is the primary capital constraint on banks, rather than a backstop to risk-weighted capital requirements, can create perverse incentives for low-risk banks to increase their overall level of risk. In the UK, this could particularly apply to institutions that performed relatively well in the recent crisis. The Government does not, therefore, see the case for permanently raising the leverage ratio beyond the Basel III standard.
>
> The Government continues to support the inclusion of a backstop leverage ratio in the EU prudential toolkit and has committed to provide the Bank of England Financial Policy Committee (FPC) with a time-varying leverage ratio direction-

95 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report*, HL Paper 98/HC 848, paras 294–6

> making tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards. This is to ensure that the UK leverage ratio is consistent with international norms, which are still under development. In the interim, the FPC will be able to address systemic risks stemming from unsustainable levels of leverage or inaccurate risk-weights using the other means at its disposal, such as recommendations or by adjusting sectoral capital requirements.
>
> The Government agrees with the PCBS that during the recent crisis the risk weights ascribed to some bank assets proved to be a poor reflection of those assets' actual riskiness. In response to this the Capital Requirements Directive (CRD) 3 (which was implemented in 2011) significantly increased the risk weights on some of the riskiest assets, such as complex securitisations. Building on this, it is clearly important that risk-weights be made as robust as possible, and the Government also notes ongoing work by bodies such as the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA) to review risk-weights internationally. With these reviews under way, the Government believes an additional UK specific assessment of risk-weights to be unnecessary.[96]

107. In its second report the PCBS explained why it disagreed with the Government's conclusions:

> The historic and prospective ineffectiveness of risk-weighting makes leverage ratios at the appropriate level all the more important as a backstop. The case for leaving the leverage requirement unchanged at 33 times when the capital requirement on banks is to be increased in line with the ICB's recommendation is therefore extremely weak. The Commission remains wholly unconvinced by the case made by the Government against a higher leverage ratio for UK banks by reference to international requirements. We propose to consider this further in our final Report.[97]

The PCBS's final Report reiterated its disappointment with the Government's response to its recommendations on the leverage ratio and urged it to reconsider its position:

> The Commission is disappointed at the Government's negative response to our recommendation in our First Report that the FPC be given responsibility for setting the leverage ratio. We have two major concerns. First, we consider that the 3 per cent minimum leverage ratio is too low. Second, we see no good reason for the Government's proposal to delay a review of the FPC's proposed power to determine leverage ratios until 2017. We note that the Chancellor's explanation regarding the Government's rejection of a higher leverage ratio relied on allegedly 'compelling' representations to the Treasury that a higher ratio would cause unintended damage; the Commission is not persuaded. If problems are created for banks with particular characteristics, they should be addressed by specific derogations not by reducing the leverage ratio for all banks.

96 HM Treasury and Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, February 2013, Cm 8545, paras 2.37–9

97 Second Report of the Parliamentary Commission on Banking Standards, *Banking reform: towards the right structure*, HL Paper 126/HC 1012, para 77

> The Commission has heard further evidence since its First Report which supports its view that the leverage ratio should be set substantially higher than the 3 per cent minimum proposed under Basel III. We noted in our First Report that the leverage ratio is a complex and technical decision best made by the regulator and it should certainly not be made by politicians. We recommended that the FPC should be given the duty of setting the leverage ratio from Spring 2013. We are disappointed that the Government has not accepted this recommendation.[98]

108. The former Commissioner Lord Lawson of Blaby moved a new clause at Committee stage in the Lords designed to give effect to the PCBS's recommendation that the FPC be given the power to set the leverage ratio. Speaking against it for the Government, the Commercial Secretary to the Treasury, Lord Deighton, described the clause as neither necessary nor desirable. He said that:

> In order to address recognised problems with the system of risk-weighted capital requirements—which we have all talked about and acknowledged—the Basel III accord recommends a complementary binding minimum leverage ratio. Again, we have all agreed that the right way ahead is for the two to work together, so there is no dispute about that. That standard comes into force in 2018, following a final calibration of the leverage ratio in the first half of 2017 so that we get it right.
>
> [...]
>
> Once that minimum is agreed domestically, the Government propose [...] to furnish the FPC with a specific macroprudential tool to vary the leverage ratio, through time, obviously subject to it not falling below the minimum.
>
> However, the question raised by the amendment is: what powers do the regulators have to take action on leverage between now and 2018 in advance of the introduction of that internationally agreed binding minimum requirement through European legislation? Let me reassure noble Lords that the regulators already have extensive powers to address the issues raised by this amendment. The FPC has broad powers to make recommendations to the regulators, on a "comply or explain" basis, including on leverage. The PRA has all the powers necessary—which we have talked about—under Section 55M of the Financial Services and Markets Act 2000 to require individual firms to take specified actions, including on leverage. Under Section 137G of FiSMA it may make rules in pursuance of its general functions, including rules on leverage ratios.[99]

Lord Lawson withdrew the new clause, but signalled that he would be likely to bring the matter before the House again at Report stage.[100]

109. However, on the first day of the Lords Report stage, on 26 November 2013, an exchange of letters between the Chancellor and the Governor of the Bank of England was published. This was almost certainly designed also to coincide with the evidence session the

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98 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, paras 1011–13

99 HL Deb, 23 October 2013, col 1032–3

100 HL Deb, 23 October 2013, col 1036

Treasury Committee was holding that day with the Governor of the Bank of England and Monetary Policy Committee colleagues.

110. The Chancellor and the Governor had agreed that the Financial Policy Committee would carry out a review into whether and when it needed any additional powers of direction over the leverage ratio, how it should use these additional powers and how any new powers would fit in with the rest of its macro-prudential 'tool-kit'. The Governor thought that the FPC's review would be likely to be completed within 12 months, and the Chancellor said that "Subject to the FPC presenting a detailed and evidence-based recommendation, I would expect to be in a position to submit its proposals in this Parliament for approval."[101]

111. The Treasury Committee asked the Governor that day about the exchange of letters, which he said "agrees to a review conducted by the FPC in an expedited fashion of the implementation of a leverage ratio for banks in the United Kingdom". He drew attention to the following aspects of the letters:

> The first is to have a leverage ratio, and our view, the view of the FPC, the view of the Bank of England and my personal view, is that a leverage ratio is an integral part of the capital framework of banks, so it is absolutely necessary.
>
> […]
>
> The second point is how the leverage ratio should vary with changes in the risk base capital framework.
>
> […]
>
> The third aspect of the letter is to give a sense around the timing […] There are a couple of important inputs before the FPC finalises its recommendations about how to implement the leverage ratio. The first is in January, in Basel, we would expect the governors and heads of supervision who oversee the Basel Committee to come to an agreement—an international agreement—on the definition of the leverage ratio and recommended minimum calibration of that leverage ratio. […] Secondly, internationally, as part of the agenda of the FSB, very much supported by the Bank and the Treasury, is to define what is called gone-concern loss-absorbing capacity—in simpler terms, although I confess it is not that much simpler, bail-inable debt. […] The third element, which is the finalisation of the Recovery and Resolution Directive of the EU and its application here, is important for the questions around the calibration and application of a leverage ratio for the ring-fenced bank as well. […]
>
> All of those factors should be finalised over the course of the coming, I would say, three quarters. The resolution aspects will take a little longer than that international definition. What we intend to do as the FPC is to work in parallel with that, come up with an evidence-based and well-reasoned recommendation to implement the leverage ratio, and we welcome the Chancellor's indication that he would, on that basis, give the FPC powers of direction over the leverage ratio.

101 Letters between the Chancellor of the Exchequer and the Governor of the Bank of England, 26 November 2013

The Governor added that he expected that the FPC would be given the power of direction "in this Parliament".[102]

112. The Committee sought clarity as to whether the FPC's review would consider whether the power should be granted, or just when. The Chancellor's letter had said that "This is now an appropriate time for the FPC to consider whether it needs additional powers". The Governor told the Committee that "I can speak best to my letter and the opinions expressed therein, and the question is how".[103]

113. The following day, the Archbishop of Canterbury, a former Commissioner, moved the same new clause at report stage in the Lords that Lord Lawson had moved in Committee. He welcomed the announcement in the letters, but asked the Government if the review would be about whether the FPC should request the powers rather than how it would exercise such a power.[104]

114. In response, Lord Deighton explained that for the Government it was indeed a question of when the power would be given rather than whether it would be given:

> The Government have already committed to give the FPC the power of direction to vary the leverage ratio through time in 2018, subject to a review in 2017, but, given progress internationally—all the transformational change that we just discussed—there is a case for such powers being given earlier, or specified in a different form. To settle this debate, the Chancellor asked the governor, who is the chair of the FPC, to review the matter and make a recommendation to him that he could take to Parliament.
>
> [...]
>
> Once that review has provided evidence to support its recommendations, the Government have committed that they will use their existing powers to grant a power of direction to the FPC before the end of this Parliament.
>
> I have a note next to me confirming that the Chancellor is happy with "when". That is probably what noble Lords really wanted to hear but I thought that it would be useful to have some background. That timetable fits in with the FPC's own timetable for defining the medium-term capital framework for UK banks. The governor has confirmed, in his letter to the Chancellor, that this timetable is appropriate.[105]

The FPC began its consultation in July 2014, and concluded it on 12 September. The FPC is expected to report its conclusions shortly.

102 Treasury Committee oral evidence: Bank of England November 2013 Inflation Report, HC 825, 26 November 2013, QQ 1–2

103 Treasury Committee oral evidence: Bank of England November 2013 Inflation Report, HC 825, 26 November 2013, QQ 3–9

104 HL Deb, 27 November 2013, col 1454

105 HL Deb, 27 November 2013, col 1456–8

Remuneration

115. Some of the PCBS's most significant recommendations concerned the reform of remuneration in the banking sector. As it said in its final report:

> Remuneration lies at the heart of some of banks' biggest problems. Risk and reward are misaligned, incentivising poor behaviour. [...]
>
> The purpose of the Commission's proposals is, as far as possible, to address the misalignment of risk and reward, and in doing so, reduce the extent to which remuneration increases the likelihood of misconduct and of taxpayer bailout. The Commission's intention is not to prevent rewards when merited—and still less to exert retribution on a group or industry—but to ensure that the rewards of banking flow only in accordance with the full long-term costs and benefits of the risks taken.

116. The PCBS made several proposals directed at banks and the regulators, including that:

- A significant proportion of executive staff's variable remuneration should be in deferred form.
- Deferral of remuneration should, in many cases, be over a longer period than currently is the case. Deferral for two or three years is likely to be insufficient to take account of the timescale over which many problems come home to roost in banking, whether in the form of high risk assets turning bad or misconduct at individual or wider level coming to light. No single longer period is appropriate, but the regulators should be able to require that a substantial part of remuneration be deferred for up to 10 years, where it is necessary for effective long-term risk management.
- Legal and contractual arrangements should be developed whereby deferred remuneration comes to be seen as contingent, so that it can be recouped in a wider range of circumstances. These might include not only enforcement action, but also a fall in bank profitability resulting from acts of omission or commission in the period for which the variable remuneration was initially paid. There should be a presumption that fines on banks should be recovered from the pool of deferred compensation as well as current year bonuses.
- In the most egregious cases of misconduct, 'clawback' of vested (and not simply deferred unvested) remuneration might be justified.
- The regulators should have the power to render void or cancel all deferred compensation of relevant bank staff in the event that that bank was in receipt of direct taxpayer support.
- In the event that a bank was in receipt of direct taxpayer support in the form of new capital provision or new equity support, or a guarantee resulting in a contingent liability being placed on to the public sector balance sheet, the regulators should have an explicit discretionary power to render void or cancel all deferred compensation, 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.

- Banks and regulators should avoid relying on narrow measures of bank profitability, particularly return on equity, in setting remuneration.
- Performance-related remuneration of non-executive directors of banks should be prohibited.
- The regulators should come forward with proposals for domestic reform of 'buy-outs', whereby firms cancel the unvested bonus awards of staff who are leaving one firm to join a competitor and the competitor compensates those staff for the forfeited award. This, the PCBS concluded, was tantamount to wiping the slate clean and, if it continued, would blunt the intended effect of its recommendations.
- Banks' statutory remuneration reports should be required to include a disclosure of expected levels of remuneration in the coming year by division, assuming a central planning scenario and, in the following year, the differences from the expected levels of remuneration and the reasons for those differences.
- The new Remuneration Code should include a provision to limit the use and scale of sales-based incentives at individual or business unit level, and for the regulator to have the ability to limit or even prohibit such incentives.
- A greater proportion of variable remuneration should be paid in the form of instruments, such as bail-in bonds, which were capable of reflecting better than equity the quality of decisions made and actions taken in the period to which the award relates. There is no package of instruments which necessarily best matched risks and rewards in each case. Flexibility in the choice of instruments was vital.
- These recommendations should apply to all staff in the Senior Managers and Certification regimes.

117. The PCBS also recommended that a new statutory Remuneration Code be introduced to implement these proposals. The Government responded, however, that any proposals could be accommodated under the existing framework, and the regulators agreed to implement any changes through revisions to the existing, non-statutory, Remuneration Code.[106]

118. On the PCBS's substantive proposals, HM Treasury and the Department of Business, Innovation and Skills expressed support for significant deferral of remuneration, deferral for longer periods and the use of bail-in bonds:

> The Government strongly supports these proposals and remains committed to ensuring that pay decisions at financial institutions are taken in accordance with the long-term best interests of the firm. The introduction of regulatory deferral periods for remuneration awards has played an important role in restructuring pay and reducing incentives to take excessive risk and therefore supporting prudential soundness. Extended deferral periods can help to further improve the alignment of

106 HM Treasury and the Department for Business, Innovation and Skills, *The Government's Response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, p 15

> individual and institutional incentives by ensuring a longer period during which variable pay can be subject to the application of malus. [...]
>
> However, as the Commission has recognised, no single deferral period is appropriate, and firms should retain the flexibility to set deferral periods in accordance with the business cycle, the nature of the business, its risks and the activities of the employee in question. [...]
>
> In terms of the instruments which comprise deferred remuneration, while the use of equity has a legitimate role to play in aligning incentives, the Government has also indicated its support for pay awards in long-term instruments such as "bail-in bonds" under new regulatory proposals.[107]

119. The regulators agreed to consider further the specifics of the proposals on deferral, the use of bail-in bonds, and the performance measures used to determine remuneration. On bail-in bonds, the FCA stated that "We [...] support the Commission's wider recommendations on remuneration, including the benefits of flexibility in firms' choice of instruments".[108] On performance metrics, the PRA said that it would "consider the Report's recommendations on the metrics and models used to measure profitability for remuneration purposes", [109] and that it planned to report by the end of 2014.[110]

120. Regarding deferral, in a letter to Mr Tyrie, Andrew Bailey, the Chief Executive of the PRA, noted that the PRA would:

> carefully consider the options available to strengthen the current approach to deferral of variable remuneration in our upcoming consultation and bring forward proposals to better align the maturity of risk and reward so as to ensure that the crystallisation of any risks taken in previous years has a measurable impact on the variable remuneration of the individuals responsible.[111]

The Governor of the Bank of England also expressed support for the direction of the PCBS's proposals on deferral, saying in a press interview in February 2014:

> We think with compensation of bankers that a substantial proportion, and an increasing proportion as they become more senior, as they take more risk, should be held back [...] it should be deferred for a very long time.[112]

The FCA said with reference to the PCBS's deferral proposals:

> The current Remuneration Code already gives regulators the power to require that a substantial proportion of remuneration be deferred for longer than the 3–5 year minimum required by CRD III/IV. We will work with the PRA on these

107 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, para 2.40

108 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, para 14

109 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, para 35

110 *Ibid.*

111 Letter from Andrew Bailey, Deputy Governor, Prudential Regulation Authority, Bank of England, 5 December 2013

112 "The Andrew Marr Show Interview: Mark Carney, Governor of the Bank of England", BBC News, 16 February 2014

> proposals and may consult on any necessary changes to the Remuneration Code in 2014.[113]

121. Regarding the PCBS's proposals for remuneration to be seen as contingent, so that it can be recouped in a wider range of circumstances, including following enforcement action, the Government said:

> The ability to reduce or recover variable pay in light of misconduct is important for managing risk, and for strengthening personal accountability. The mechanism for such pay recovery usually operates through the application of malus[114] or clawback.[115] The Remuneration Code requires firms to have a performance adjustment (malus) policy in place to reduce or revoke pay where subsequent information on poor performance comes to light, which reduces incentives to engage in misconduct and ensures the accountability of individuals.
>
> The Government expects a proactive approach to the application of these policies where there is evidence of misconduct [...].
>
> The Commission rightly highlights that deferred remuneration should be seen as contingent, so that it can be recouped in a wider range of circumstances. The Government agrees with this approach. [...][116]

The FCA, in its response to the PCBS, said:

> We [...] support the Commission's wider recommendations on remuneration, including [...] the development of legal and contractual arrangements to allow deferred remuneration to be recouped in a wider range of circumstances.[117]

The PRA agreed to consider the recommendation further, and noted that:

> In determining bonus pools firms should consider the size and nature of any regulatory fines alongside evidence of risk management failure, increased business risk, poor financial performance and reputational damage.[118]

122. In specific relation to clawback, the Government said:

> The Government agrees that the accountability of individuals for long tail misconduct risks should not be removed upon the vesting of remuneration, and clawback should play a greater role in complementing the application of malus. However, as the Commission has noted, there are legal and practical obstacles to

113 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 21

114 Malus allows a bank to prevent the rights to all or part of a deferred bonus vesting with an individual [Committee note].

115 Clawback refers to a contractual agreement whereby an individual agrees to return ownership of vested remuneration to an institution under certain circumstances [Committee note].

116 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, paras 2.43–2.45

117 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, para 14

118 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, 7 October 2013, para 18

> clawback and limits on when it can be applied. The Government will therefore ask the PRA to consider appropriate ways in which to strengthen clawback, as part of its implementation of the Commission's proposals.[119]

In March 2014, the PRA published a consultation proposing rule changes that would require firms to amend employment contracts to enable them to clawback vested remuneration for up to six years following the point of vesting.[120] Circumstances in which clawback could be applied would include:

- there being reasonable evidence of employee misbehaviour or material error;
- the firm or the relevant business unit having suffered a material downturn in its financial performance; or
- the firm or the relevant business unit having suffered a material failure of risk management.

These changes would in important respects go further than the PCBS's proposal, which was that recovery of vested remuneration might be justified in the most egregious cases. The FCA announced no further steps in terms of clawback, but noted in its response to the PCBS that "We believe we already have sufficient powers to implement this recommendation".[121]

123. The Government undertook to ask the PRA to consider the PCBS's proposal in respect of taxpayer-supported banks:

> The Government agrees that there should be specific powers available for the regulator in relation to remuneration at banks in the event of the bank requiring state assistance. The ability to reduce or revoke deferred remuneration when a bank requires state aid would further strengthen accountability, and complement the extensive reforms which the Government has undertaken to remove the implicit taxpayer guarantee. The reforms introduced under CRD4 have reinforced existing rules on pay at banks in receipt of state support, requiring that: bonuses are strictly limited where inconsistent with the maintenance of a sound capital base and timely exit from Government support; regulators will be able to require banks to restructure remuneration in a way aligned with sound risk management and long-term growth; and directors should not receive a bonus unless justified.
>
> The Government will seek to build on these reforms by asking the PRA to consider the scope to reduce or revoke deferred compensation, unvested pension benefits, loss of office payments where a bank requires certain forms of state support, the population to which these rules should apply and whether further powers are desirable in this regard.[122]

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119 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, para 2.46

120 Prudential Regulation Authority, Clawback, CP6/14, March 2014

121 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, p 22

122 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, para 2.48–2.49

Lord Newby, speaking for the Government on the third day of Lords Committee stage of the Financial Services (Banking Reform) Bill, added that:

> extending these powers to cover the removal of pension benefits which have not yet become payable, but which the individual concerned has a contractual right to receive, is difficult. That would restrict the rights of the individual concerned under the European Convention on Human Rights to the "peaceful enjoyment" of his or her possessions. The Government do not consider that this would be appropriate. The PRA will consult further on these issues early next year, including on the details of how the powers should be drafted and the population of staff to whom it should apply.[123]

In its response to the PCBS, the PRA confirmed that it would consider how to address the proposal "consistent with European Human Rights provisions".[124]

124. Neither regulator originally accepted that the PCBS's remuneration proposals should apply to all staff in the Senior Manager and Certification regimes. The FCA said that:

> The current Remuneration Code and relevant Directives only apply to 'Material Risk Takers'—those individuals who pose the greatest risk to the financial stability of an institution. Applying the Code to other individuals would go well beyond the international standards on remuneration.[125]

The PRA stated:

> The revised Code will continue to apply to those staff who have a material impact on a firm's risk profile—'material risk takers'.[126]

125. However, in an update in March 2014, the PRA noted that:

> The draft EBA Regulatory Technical Standard on material risk takers will increase significantly the numbers of individuals in firms identified as risk takers and subject to the provisions of the Remuneration Code.[127]

The FCA made a similar observation, and said that "it is likely that staff within the Senior Managers and Certified Persons Regimes will be subject to the widened definition of material risk takers".[128]

126. In July 2014, the regulators published a consultation on changes to the Remuneration Code designed to implement the PCBS's proposals.[129] The main proposals were as follows:

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123 HL Deb, 23 October 2013, col 1055

124 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, 7 October 2013, para 15

125 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, para 15

126 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, 7 October 2013, para 16

127 Bank of England, *Bank of England progress update on PCBS recommendations*, p 6

128 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 4

- Deferral—The regulators proposed minimum deferral periods for individuals in the Senior Managers Regime of seven years, with no vesting of deferred pay until the third anniversary of award. Minimum deferral periods for all other individuals covered by the Code would be five years, with vesting allowed from the point of award. The current Remuneration Code stipulates a minimum deferral period of three to five years in all cases. The regulators also said they would be able to use their powers to 'impose requirements' under Section 55M of FSMA 2000 to require firms to defer pay for ten years if necessary, in line with the PCBS's recommendation.

- Bailed-out banks—The regulators proposed to make explicit in the Remuneration Code the presumption that all discretionary payments, including payment for loss of office and discretionary pension benefits, should be stopped or restricted in the event of a bank receiving taxpayer support.

- Risk adjustment—The PRA noted that some of the models that firms use for determining profits have been criticised for overstating those profits. The PRA also agreed with the PCBS's concern that there was over-reliance on metrics such as Return on Equity (RoE) and Total Shareholder Return (TSR) in determining performance. The PRA therefore proposed to require firms: to calculate their profits using a 'prudential valuation adjustment', which would ensure that firms accounted appropriately for risks when setting pay; and not to rely on narrow measures such as RoE and TSR when determining variable remuneration.

- Remuneration of non-executive directors—As recommended, the regulators proposed to make explicit in the Remuneration Code that non-executive directors of banks should not receive variable remuneration.

- Buy-outs—The regulators agreed with the PCBS's concern that 'buy-outs' could insulate individuals against the risk of downward adjustment of their past awards when they move between firms. Recognising the complexities of the issue, the regulators put forward four possible approaches and invited views. In particular, the regulators invited comments on: banning buy-outs; maintaining unvested awards when an individual moves between firms; applying malus to bought-out awards; and relying on clawback instead of malus.

127. The regulators rejected the PCBS's proposal to require banks to disclose expected levels of remuneration for the coming year, since a range of new disclosure requirements had been introduced since the PCBS's final report, and these had already significantly enhanced remuneration reporting obligations. The regulators were also concerned that publicly disclosed forecasts would be unreliable.

128. The FCA also rejected the PCBS's proposal to amend the Remuneration Code to limit the use and scale of sales-based incentives. The PCBS concluded that such schemes had contributed to conduct failures, including scandals such as PPI. The FCA noted that the guidance it published on such incentives in January 2013 had already resulted in significant change and increased awareness and focus on financial incentives. The FCA agreed,

129 Financial Conduct Authority and Prudential Regulation Authority, *Strengthening accountability in banking: a new regulatory framework for individuals*, FCA CP14/13, PRA CP14/14, July 2014, p 15

however, to revisit financial incentive schemes for sales staff as it implements MiFID II and MiFIR II.

129. Alongside the July 2014 consultation, the PRA published its final rules on clawback. Compared to the March 2014 proposals, these rules restricted the set of circumstances in which firms were required to have arrangements to recover vested remuneration. Specifically, clawback will no longer apply in cases where the firm or the relevant business unit simply suffers a material downturn in its financial performance. In addition, instead of being able to recover pay for six years from the point of vesting, firms should be able to recover it for seven years from the point of award. The regulators proposed that this seven year period could be extended to ten years in cases where there was an ongoing inquiry into events which could potentially lead to clawback.

130. The proposed combined scope of the PRA's Senior Managers and Certification Regimes will broadly overlap with the set of individuals classed as 'material risk takers'. This largely accords with the PCBS's recommendation that its remuneration proposals should apply to all staff in the new regulatory regimes for individuals. The FCA's Certification Regime will extend, however, to some individuals who are not 'material risk takers'. Such individuals will fall outside the reach of the new Remuneration Code, and therefore of the PCBS's proposals.

Enforcement decision-making

131. The PCBS took evidence on the enforcement arrangements in place for the banking sector. It drew several conclusions:

- There was an inherent tension between the role of real-time regulators and the enforcement function, which could involve reaching judgements about matters in which supervisors were involved at the time.
- The enforcement function required adequate resources, and leadership with a willingness to pursue even the difficult cases, often involving the larger and more powerful players, in order to build up a credible deterrent effect.
- The body responsible for making enforcement decisions arising from the work of the FCA, namely the Regulatory Decisions Committee (RDC), was not best suited to the specific enforcement needs of the banking sector, since it contained neither a depth of banking expertise nor a clear lay element separate from banking and allied financial services sectors.[130]

132. In an effort to address these concerns, the PCBS made a number of recommendations concerning the composition of the enforcement decision-making body for financial services:

> The Commission recommends the creation of an autonomous body to assume the decision-making role of the Regulatory Decisions Committee for enforcement in relation to the banking sector. The body should have a lay (non-banking or financial

130 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, paras 247–249

> services professional) majority, but should also contain several members with extensive and senior banking experience. The body should be chaired by someone with senior judicial experience.[131]

The PCBS also made recommendations in respect of this new body's governance, and proposed that it should take on decision-making responsibilities for enforcement action brought by the PRA (which currently sit with the PRA Board):

> The body should have statutory autonomy within the FCA. It should be appointed by agreement between the boards of the FCA and PRA. The body should also assume responsibility for decision-making in respect of enforcement action brought by or under the auspices of the PRA. The new body should publish a separate annual report on its activity and the lessons for banks which emerge from its decisions, and the chairman should appear before Parliament, probably the Treasury Committee, to discuss this report.[132]

While the scope of the PCBS's report was restricted to banking, it also recommended that:

> the FCA and the PRA be required to publish a joint review of the working of the enforcement arrangements for the banking sector in 2018. This should, as part of its work, consider whether a separate statutory body for enforcement as a whole has merit. [133]

133. While the Government welcomed the PCBS's consideration of this area, it did not agree with its conclusions:

> The current system gives the regulators discretion to design their decision making framework in a way that best suits their resources and regulatory approach. It is the case that an external RDC would be performing a role similar to that of a tribunal, and regulatory issues are already dealt with by the Upper Tribunal. The benefit of adding an extra layer of quasi-judiciary process is not clear and would likely lead to increased costs. This was a matter aired at some length during the passage of the Financial Services Act 2012. At this stage, the Government does not consider that change is required.[134]

134. The FCA acknowledged the PCBS's proposals on the current composition of the RDC, but noted that:

> We have recently appointed three additional members to the RDC, two of whom have senior banking experience.[135]

131 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 250

132 *Ibid.*

133 *Ibid.*

134 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, para 5.40

135 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 37

135. Speaking on the second day of Lords Report stage of the Financial Services (Banking Reform) Bill, the former Commissioner Lord Turnbull explained why consideration of the enforcement arrangements for the financial services sector was important:

> [I]n banking at least, enforcement decisions could be taking on a greater significance than in the past. Indeed, the past has been characterised by a surprising absence of enforcement, at least in relation to the events of the financial crisis. There have been some major enforcement decisions and some colossal fines around conduct, but virtually none in relation to events leading up to the financial crash. This therefore raises the question as to whether the RDC needs to be upgraded in terms of its chairmanship and membership so that it is capable of handling bigger and more important cases.
>
> [...] [I]n response to a regulatory infraction or lapse, there is a balance to be struck between using enforcement as an instrument and the supervisory instrument. We should not get into the mode of thinking that enforcement is always the first and best recourse. Supervisors may take the view that a case is better handled by what elsewhere might be called "special measures", such as seeing that the people who are responsible for the poor behaviour and decisions are moved on, and possibly even sacked; or by getting new people in; or by securing undertakings from management about future conduct. Often, this can produce a quicker and more effective result, whereas recourse to enforcement can cut across this so that instead of a bank immediately getting into a constructive dialogue about what to do next, it begins to dig in and wait for a long, drawn-out litigation.
>
> We therefore need to ensure that, in any particular case, the full range of options has been considered and that the interests of other regulators have been taken into account. In other words, the RDC should only receive a case after that balancing process has taken place. It would be helpful if the RDC was able to question whether all the options and possible responses have been explored.
>
> [...] [I]n many walks of life, there has been a trend which continues to this day of greater separation between those investigating a case, those who decide whether a prosecution should be undertaken and those who reach a verdict. You could go back to the creation of the Crown Prosecution Service more than two decades ago, and you can see this in a number of professional bodies covering medicine, solicitors and accounting. The hot topic of the moment is the Independent Police Complaints Commission. There is a perception that the RDC is not as independent of enforcement as it could be. It is co-located. It is part of the FCA. Would we be able to achieve both actual enhancement of its independence and, certainly, the perception of that independence if it stood in a more independent position?
>
> Finally, the RDC has to ensure that before any accusation is made in a decision notice that enforcement has been properly researched, the accused has been given a proper chance to put their case, and the case has been gone into thoroughly. This is of particular relevance to smaller practitioners who can be severely damaged by accusations and are not able to clear their name until maybe years later. Unlike big

firms, such businesses, such as IFAs, can find that they clear their name but there is no business left to go back to.[136]

136. Noting that the Government had rejected the PCBS's original proposal for a new decision-making body with statutory autonomy, and a review by the FCA and PRA of enforcement arrangements by 2018, Lord Turnbull concluded:

> Rather than attempt to legislate now in a process that does not allow proper consultation with practitioners, and which would be confined only to banks, I argue that we should have a wider review.
>
> […]
>
> there is more than enough material on which to base a review and no reason to delay that until 2018, which was included in the earlier amendment.[137]

137. Lord Deighton, Commercial Secretary to the Treasury, subsequently wrote to Mr Tyrie accepting this proposal:

> I have noted the issues that have been raised in the PCBS and during Bill debates Given the concerns of the PCBS on these issues, I agree that it would be appropriate to conduct a high-level review into the institutional arrangements and processes for enforcement decision-making and appeals at the financial services regulators.
>
> The Treasury will lead the review, which will be independent of the regulators, but will require their co-operation. The review will draw on independent professional advice as appropriate, and will consult broadly with regulated firms, industry trade bodies and consumer groups.
>
> The Treasury will determine the terms of reference of the review following consultation with the Chairman of the Treasury Select Committee in the first quarter of 2014, and make them public. The review should report in the autumn of 2014. The Treasury will arrange for the report to be published and laid before Parliament.[138]

138. The then Financial Secretary to the Treasury wrote to Mr Tyrie on 10 February 2014 to propose the following terms of reference:

> The Review will consider the design and governance of the institutional arrangements and processes at the regulators against the principles and taking account of the respective roles of the FCA and the PRA, as well as the relationship between these processes and the Upper Tribunal. In particular, the Review will consider the key decision points in relation to:
>
> the interface between supervision and enforcement, particularly the decision making process for referring cases for enforcement investigation and possible action;

136 HL Deb, 27 November 2013, col 1461–1462

137 HL Deb, 27 November 2013, col 1462

138 Letter from Lord Deighton of Carshalton, KBE, Commercial Secretary, HM Treasury, 4 December 2013

> the approach adopted by the regulators to co-ordinating investigations and enforcement action;
>
> the arrangements for the subjects of enforcement action to understand the case against them and to make representations to the regulators;
>
> the operation of the settlement process, including the incentives for early settlement;
>
> the operation of the respective post-investigation administrative processes for reaching disciplinary decisions in the FCA and PRA and including: the composition and accountability of the decision making committees; the degree of separation of the decision making process from the investigatory process; and the arrangements for referring cases to the Upper Tribunal.[139]

The Minister subsequently also confirmed in a letter to Mr Tyrie that all the following matters suggested by the PCBS would fall within the terms of reference review:

> that an appropriate balance must be struck between the use of supervisory and enforcement powers in response to any regulatory infraction or lapse, and that the full range of options should be considered in any particular case;
>
> that the enforcement decision-making body must have the right chairmanship and membership to allow it to handle the most important cases, for example in relation to the sort of events which led up to the financial crisis;
>
> that there should be an appropriate degree of separation between those investigating a case and those making the final decision on it; and
>
> that enforcement cases should be properly researched, and those subject to potential enforcement should be given proper opportunity to put their cases across, before decision notices are issued.[140]

139. On 6 May 2014 the Government announced a review of the fairness, transparency, speed and efficiency of the institutional arrangements and processes for enforcement decision-making at the PRA and the FCA. The review included a consultation exercise and would cover:

> the process for referring cases for enforcement investigation; the process for coordinating investigations and enforcement action taken by the FCA and PRA; the operation of the early settlement process; the operation of the post-investigation administrative processes for reaching disciplinary decisions; the arrangements for the subjects of enforcement action to make representations to the regulators; […] the arrangements for referring cases to the Upper Tribunal [; and] a comparison of these arrangements with international practice.[141]

139 Letter from the Financial Secretary to the Treasury to the Chairman of the Treasury Committee, 10 February 2014

140 Letter from the Financial Secretary to the Treasury to the Chairman of the Treasury Committee, 2 April 2014

141 HM Treasury, *Review of enforcement decision-making at the financial services regulators: call for evidence*, 6 May 2014

The consultation closed on 4 July 2014. The review will report to the Chancellor in autumn 2014.

Special measures

140. One of the PCBS's conclusions on twin peaks regulation—in which prudential and conduct supervision is carried out by separate regulators—was that:

> [It] carries the risk that, by focusing on their own individual objectives, the regulators fail to spot or tackle systemic weaknesses of leadership, risk management and control which underpin problems in different parts of the business.

With this in mind, the PCBS concluded:

> that the regulators should have available to them a tool, along the lines of the pro-active approach taken in the US, to identify and tackle serious failings in standards and culture within the banks they supervise. Use of the tool may be a precursor to formal enforcement action by the regulator if the bank fails to address the regulator's concerns satisfactorily. [142]

The PCBS described this tool as follows:

> As part of the continuing dialogue between the PRA and the FCA at the most senior levels within the two organisations, and through their risk assessment frameworks, we expect the two regulators to consider cases which might require the deployment of the tool we propose, which can be termed 'special measures'. Special measures will take the form of a formal commitment by the bank to address concerns identified by the regulator. Ahead of placing a bank in special measures, we consider that the regulators should commission an independent report to examine the extent to which their initial source of concern may be an indicator of wider conduct or standards failings. It will be important for such reports to be truly independent. We consider it inappropriate therefore for a bank's auditors, or those who might compete to become the firm's auditors in the near future, to be appointed to carry out this task. There would be an expectation that reports would be prepared quickly.
>
> Where the report reveals problems requiring rectification or there remains cause for regulatory concern, the Commission recommends that the regulators have a power to enter into a formal commitment letter with the bank concerned to secure rectification measures and to provide a basis for monitoring progress in addressing the concerns. The Commission recommends that a bank in special measures be subject to intensive and frequent monitoring by the regulators. An individual within the bank should be made responsible for ensuring that the remedial measures are implemented to the regulators' satisfaction. As part of this process, the regulators might wish to require the retention of an independent person to oversee the process from within the bank. [...]

142 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL 27–I/HC 175–I, para 190

> Before the deployment of special measures, we would expect the regulators to notify the bank in question, and give the leadership of that bank a reasonable opportunity to demonstrate that it is addressing the concerns of the regulators or to convince the regulators that the concerns are misplaced.[143]

141. The Government welcomed the PCBS's interest in this area, but noted that "the objectives of the recommendation seem achievable under the regulators' existing powers, so legislation to create a separate 'special measures' regime appears unnecessary".[144]

142. The regulators similarly supported the principle behind the recommendation but thought new powers unnecessary. The PRA said in its response:

> The PRA agrees with the intention of the recommendation—to help identify and tackle serious failings in standards and culture—but does not believe that any new powers are necessary. The PRA has a range of intervention powers, including the power to commission a 'section 166' report by a skilled person and to impose requirements on firms under section 55M of FSMA. The possible form of such requirements may include, for example, a commitment letter from the firm to the PRA and the nomination of an individual within the firm to take responsibility for fulfilling the commitments therein (both envisaged by the Report).[145]

And the FCA stated:

> We believe the objectives of this recommendation are achievable under existing powers, which can replicate all the steps in the Commission's description of 'special measures'. For example, under the Financial Services and Markets Act (2000) we have a range of powers where we can require a firm to start or stop a particular activity.[146]

143. During debate on the Third Day of Lords Committee Stage of the Financial Services (Banking Reform) Bill, the former Commissioner Lord Turnbull said in reference to these responses:

> the argument against all these cases where we have these powers already comes back to if that is case, how did we get into this problem in the first place? What we are trying to establish is whether things will be different in the future. It would help us judge that better if the PRA/FCA could produce a working document on how they envisage using powers of this kind—a special measures regime—where they are looking for generalised improvements in the culture and the way that a bank is being managed.[147]

144. The Chief Executives of the PRA and FCA both subsequently wrote to Mr Tyrie about this proposal. Andrew Bailey agreed that:

143 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, paras 191-193

144 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, para 5.39

145 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, para 33

146 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, para 37

147 HL Deb, 23 October 2013, col 1059

> the PRA will publish a statement of policy in 2014, which will explain in greater detail the tools available to us, and how the PRA's expected use of its powers can respond to the scenarios envisaged in the PCBS report. The statement will also describe the way in which the PRA will use its supervisory approach and statutory powers to pro-actively tackle failings in standards and culture in firms.[148]

For the FCA, Martin Wheatley stated:

> We intend to publish a statement of policy in 2014 which describes these powers and explains how they enable us to deliver the actions described in the PCBS report. [...] The FCA has a significant range of powers to identify and tackle serious failings either to rectify existing problems or prevent further consumer loss or reputational damage to markets. Our 2014 statement will set out our powers and practices, including powers to impose requirements on firms to undertake or cease a particular action, directly contract independent monitors to ensure a firm's compliance and require firms and/or senior individuals to attest that remedial actions have been completed. In addition, the statement will seek to address PCBS concerns that the split between prudential and conduct regulation will result in a system that overlooks systemic cultural weakness.[149]

145. The two regulators issued their promised policy statements on 19 June 2014.[150] The PRA said that the practices set out in its document were consistent with its current approach. The PRA said that it would identify serious failings in culture through its normal supervisory activity; it was not limited to individual serious occurrences, but might also include: multiple examples of a firm failing to conduct its business in a safe and sound manner; evidence of a poorly functioning board; evidence of weak control, for example risk, compliance or internal audit; or weaknesses in board or senior manager behaviour. If the PRA identifies deficiencies, including cultural ones, it says that its 'Proactive Intervention Framework' may change, with more intense supervision or additional reporting requirements. The PRA might require the firm to correct deficiencies in a set period. The PRA might proceed to an enforcement investigation without having exhausted all other supervisory options, and might choose to deploy formal powers at an early stage. The PRA might commission a report from a "skilled person" under section 166 FSMA, with a time limit for its production—it can contract directly with the skilled person if necessary to ensure independence. The PRA might require a firm to undertake or cease a particular action. It might require the nomination of a person within the firm to take responsibility for the PRA's recommendations, or might require an independent person to ensure compliance. The PRA also noted its power on its own initiative to vary firms' permissions, which could extend as far as withdrawal of authorisation.[151]

146. The FCA announcement set out how its powers could be used to deliver the PCBS recommendations. It would be able to commission independent reports and oversight under section 166 FSMA; it said that it already discussed concerns with firms; it would

148 Letter from Andrew Bailey, Deputy Governor, Prudential Regulation Authority, Bank of England, 5 December 2013

149 Letter from Martin Wheatley, Chief Executive, Financial Conduct Authority, 6 December 2013

150 Financial Conduct Authority, *Tackling serious failings in firms*; Prudential Regulation Authority, *The use of PRA powers to address serious failings in the culture of firms*.

151 Prudential Regulation Authority, *The use of PRA powers to address serious failings in the culture of firms*

require formal commitments from boards that they would deal with issues within an agreed time, and could require "attestations" to obtain formal confirmation from responsible senior individuals that they will take steps to deal with a specific issue and that they accept accountability for doing so.

147. The FCA also outlined a new approach, known as "Enhanced Supervision", in order to meet the recommendations of the PCBS. This would apply where a serious failure of standards poses a risk to its objectives and its normal approach would not enable it to tackle the failure quickly enough. The main elements of Enhanced Supervision will include a formal commitment from the firm in question's board to address the underlying issues; a formal review of the supervisory approach; and consideration of the use of all the tools available to the FCA.[152]

148. The PRA and FCA noted their statutory duty to co-operate with each other, and the memorandum of understanding that exists describing how the regulators fulfil this duty. The regulators will discuss concerns with each other and where possible come to a common view on the underlying issues and the proposed course of action, and take joint action if appropriate. Both regulators may, however, take action individually where the other does not wish to do so. [153]

Embedding a pro-competition culture at the FCA: authorising new entrants and alternative providers

149. A number of witnesses appearing in front of the PCBS expressed concern that the FCA might fail to deploy its new competition powers to full effect, for reasons including that "regulators tend to regulate and they do not think about competition as a tool they can use", and that "[i]t is not that [the FCA] is not willing; it is just that it does not have any people there who have ever worked in this area".[154] The PCBS recommended that:

> The FCA must—as a matter of priority—embed a robust pro-competition culture which looks to competition as a primary mechanism to improve standards and consumer outcomes.[155]

150. This recommendation was supported by the Government in a letter from the Chancellor to Mr Tyrie on 10 January 2014.[156] Responding to the PCBS's report, the FCA said:

> We are committed to embedding a pro-competition culture throughout the organisation, with expertise at board, executive and working level. We have recently announced our programme of work into competition for the year ahead, including a market study into cash savings, and a strategic review of wholesale markets. We have

152 Financial Conduct Authority, *Tackling serious failings in firms*, June 2014, p 9

153 Financial Conduct Authority and Prudential Regulation Authority, *Memorandum of Understanding (MoU) between the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)*

154 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, paras 1075–1076

155 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 214

156 Letter from Rt Hon George Osborne MP, Chancellor of the Exchequer, HM Treasury, 10 January 2014

> built and continue to expand a team with significant competition expertise, and are building the capabilities of existing staff through a programme of competition training.[157]

151. The FCA issued an update to this statement in March 2014, pointing to a number of senior appointments that it had made to its new Competition division, and also noting:

> We are rolling out competition training to all our staff and are reviewing our historic rules and procedures to ensure that our regulatory regime promotes effective competition and all future policy development will consider how to achieve the desired outcome in the most pro-competitive way.[158]

In a speech on 16 October 2014, Martin Wheatley further described the FCA's commitment to supporting competition in UK financial services:

> In the aftermath of the financial crisis, we saw competition in many financial markets lessen as concentration increased.
>
> Today, the outlook is different. We see new entrants joining the market, or poised to join. We see new models shake up established markets – peer-to-peer lending being only the most fashionable.
>
> Our reaction to these developments will be one of the defining characteristics of the FCA, helping to shape a market that offers consumers alternatives, products that meet their needs, delivered in a way that fits with how they live.
>
> […]
>
> But competition will not simply sit as a discrete function within the FCA – the responsibility of a handful of teams. Instead, we have to bring competition thinking, as it relates to our objectives and remit, into every decision, in every rule, in every action we take.[159]

Mis-selling at the point of sale

152. The PCBS heard extensive evidence on the mis-selling of financial products, and made numerous recommendations designed to bear down on such practices. It proposed that those who design and market products should be held responsible should those products be mis-sold to consumers, and that it should be banks' duty to ensure that products are not sold to the wrong people and that staff incentives do not contribute to mis-selling.[160]

153. However, the PCBS was also clear that:

157 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 11

158 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 4

159 Speech by Martin Wheatley at the Mansion House, 16 October 2014

160 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 187

> if these steps are properly taken, the mere discovery of risk in products cannot be held to constitute mis-selling, where such risks could not reasonably have been identified based on the information available either to the bank or to the regulator at the time that they were sold.[161]

154. In a letter to Mr Tyrie on 10 January 2014, the Chancellor supported the PCBS's position, noting that:

> The Government agrees that it would not be appropriate for regulators to use their powers to find a firm, or its senior managers, guilty of a breach they could not have possibly forseen.[162]

155. The Chief Executive of the FCA, Martin Wheatley, also agreed with the PCBS's conclusion, stating in a letter to Mr Tyrie:

> We do not apply different standards or interpret rules differently with hindsight. However, if this concern is widely expressed by industry in their discussions with you then I would entirely agree that this is not helpful for either firms or the regulators, nor is it the regulatory intent.
>
> The requirement to only act against a reasonable interpretation of the rules and principles that were in force at the time mis-conduct occurred, taking into account the information reasonably available at the time decisions were taken, is hardwired into our formal rules and guidance. [163]

Mr Wheatley further noted that the FCA would undertake a consultation in the first half of 2014 "where firms will be invited to provide feedback, including clear examples, of where industry believes the regulators have taken retrospective action".[164]

156. The FCA published a 'Call for examples' in late August 2014, which asked industry participants to provide examples of when they believed the FCA, or FSA, had applied regulatory rules retrospectively (that is, applied a more demanding standard or interpretation of the rules after the event with the benefit of hindsight). It posed four specific questions to respondents: what was the main example of retrospective application of rules by the FCA or the FSA; what in particular justified the label 'retrospective' in the example; what other examples there were of retrospective application of rules by the FCA or the FSA; and whether respondents had any other feedback or suggestions in relation to the issue of retrospection. The window for comments extended to 10 October. The FCA is considering responses.

161 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 187

162 Letter from Rt Hon George Osborne MP, Chancellor of the Exchequer, HM Treasury, 10 January 2014

163 Letter from Martin Wheatley, Chief Executive, Financial Conduct Authority, 6 December 2013

164 *Ibid.*

Whistleblowing

157. The PCBS described its shock at the evidence it heard that "so many people turned a blind eye to misbehaviour and failed to report it".[165] It concluded that:

> the financial sector must undergo a significant shift in cultural attitudes towards whistleblowing, from it being viewed with distrust and hostility to one being recognised as an essential element of an effective compliance and audit regime. Attention should focus on achieving this shift of attitude.[166]

158. To this end, the PCBS made a number of recommendations in respect of whistleblowing in the banking sector, notably that:

- institutions must ensure that their staff have a clear understanding of their duty to report an instance of wrongdoing, or 'whistleblow', within the firm;
- banks must have in place mechanisms for employees to raise concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing;
- a non-executive board member—preferably the Chairman—should be given specific responsibility under the Senior Persons Regime for the effective operation of the firm's whistleblowing regime, and be held personally accountable for protecting whistleblowers against detrimental treatment;
- whistleblowing reports should be subjected to an internal 'filter' by the bank to identify those which should be treated as grievances—'whistleblowing' being treated as individual grievances could discourage legitimate concerns from being raised;
- all Senior Persons should have an explicit duty to be open with the regulators;
- the regulators should periodically examine a firm's whistleblowing records, both in order to inform itself about possible matters of concern, and to ensure that firms are treating whistleblowers' concerns appropriately;
- the regulators should determine the information that banks should report on whistleblowing within their organisation in their annual report;
- the regulators should undertake research into the impact of financial incentives in the US in encouraging whistleblowing, exposing wrongdoing and promoting integrity and transparency in financial markets;
- the FCA should regard it as its responsibility to support whistleblowers, providing feedback to the whistleblower about how the regulator has investigated their concerns and the ultimate conclusion it reached, and requiring banks to inform it of any employment tribunal cases brought by employees relying on the Public Interest Disclosure Act where the tribunal finds in the employee's favour; and

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165 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 142

166 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 151

- the regulator should be empowered in cases where as a result of an enforcement action it is satisfied that a whistleblower has not been properly treated by a firm, to require firms to provide a compensatory payment for that treatment without the person concerned having to go to an employment tribunal.[167]

159. In response to these recommendations, the Government noted that the Department for Business, Innovation and Skills was publishing a 'call for evidence' on the operation of the whistleblowing framework in today's employment environment, and that it would consider the PCBS's proposals in the context of this wider review.[168] The Government published its response to this consultation in June 2014.[169]

160. The PCBS's proposals on whistleblowing were directed primarily at banks and the regulators. The regulators agreed with the PCBS's recommendations in respect of Senior Persons, but generally undertook only to consider further its other proposals. The PRA stated:

> The PRA agrees that a non-executive should be given specific responsibilities in relation to whistleblowing, and that all Senior Persons should have an explicit duty to be open with the regulator. The PRA will bring forward proposals as part of its consultation on the Senior Persons regime. The Report also recommends that the regulator undertake research into the impact of financial incentives for whistleblowing in the United States. The PRA, together with the FCA, is assessing the benefits and drawbacks of incentivisation and will make recommendations in 2014.
>
> The Report's other recommendations on whistleblowing would intensify the exchange of information between the firm and the regulator on particular whistleblowing cases, expect the regulator periodically to examine the whistleblowing records of firms and determine the information on whistleblowing that firms should disclose in their annual report, and empower the regulator to require firms to provide compensatory payments in particular cases of whistleblower mistreatment. The PRA, in liaison with the FCA, will give further consideration to these recommendations including the scope to advance them, if appropriate, through existing legislation.[170]

161. In its October 2013 response to the PCBS, the FCA said:

> [We] believe a culture where people are prepared to speak up can significantly improve behaviour throughout a firm, and ultimately improve consumer outcomes. Formal whistleblowing practices play an important role in creating this culture but should not be a first port of call. If staff have a good understanding of conduct

167 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, paras 142–152

168 Department for Business Innovation and Skills, *Whistleblowing framework call for evidence, Government response*, June 2014, p 20

169 Department for Business Innovation and Skills, *Call for evidence: The Whistleblowing Framework*, July 2013

170 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, 7 October 2013, paras 38–39

> standards, and feel secure about speaking out, they will inform senior management when they see malpractice occurring, through both informal and formal channels.
>
> These are principles which apply beyond banking, across the whole financial services industry. We will consult in 2014 on whether additional rules are needed to set minimum standards for whistleblowing and how prescriptive these should be. This consultation will include the proposal that a member of a firm's senior management is made personally accountable for whistleblowing procedures. [171]

In an update in March 2014, the FCA went further in its support of setting clear standards for whistleblowing procedures:

> We […] need to define clear regulator standards for firms' procedures. We have established cross-departmental team within the FCA to take this work forward. The team is working closely with the PRA and is liaising with the Government on their review of the wider legal framework for whistleblowing. Subject to these discussions, we will publish a separate paper on whistleblowing later this year.[172]

162. The regulators' consultation on the Senior Managers Regime in July 2014 explicitly included responsibility for a firm's whistleblowing framework, and the protection of whistleblowers, in the list of 'Prescribed Responsibilities' which must be allocated to an individual in a firm.

163. The FCA agreed to the PCBS's proposal to conduct research into the impact of financial incentives in encouraging whistleblowers. Reporting jointly with the PRA on this research in July 2014, the FCA said:

> We consider that providing financial incentives to whistleblowers will not encourage whistleblowing or significantly increase integrity and transparency in financial markets.
>
> There is no empirical evidence to suggest that the US system raises either the number or the quality of whistleblowing disclosures within financial services. Nor do the incentives in the US model appear to improve the protection available to whistleblowers. What whistleblowers tell us they would like is better protection for all whistleblowers rather than large payments to a tiny minority. This is consistent with the findings of the BIS Call for Evidence, and with the proposals for action by businesses and regulators that BIS have now published, which reject the idea of financial incentives as an integral part of the whistleblowing framework.
>
> We therefore propose not to introduce financial incentives, but to press ahead with the regulatory changes necessary to require firms to have effective whistleblowing procedures, and to make senior management accountable for delivering these.

164. In relation to the PCBS's other recommendations, the FCA said:

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171 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, paras 23–26

172 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 14

> The Commission recommends that regulators support whistleblowers and give feedback to them on how their concerns have been addressed. Although we do not believe it appropriate to disclose whether a firm is under investigation, we will be able to publish information about a Warning Notice when disciplinary action begins against a firm, and will ensure that, where appropriate, we tell whistleblowers when this happens. We are looking at how transparency can be increased further and will engage more actively with whistleblower support groups on this issue. [...]
>
> We support the recommendation that firms must inform the FCA of any successful tribunal cases brought by employees relying on the Public Interest Disclosure Act. For deposit takers, we will implement this with an obligation on the relevant Senior Person to report these cases to us. Our consultation will also consider how to apply this principle across the wider industry. [173]

But on this last recommendation, the FCA noted in an update in March 2014 that it was "conscious of the burden placed on firms by our data requests and this proposal would require cost-benefit analysis".[174]

165. The FCA supported the PCBS's recommendation that staff must understand their duty to report wrongdoing, and said it would "consider building this into the new Individual Standards Rules".[175] No explicit duty of this kind was included in the conduct rules published for consultation in July 2014, however. The FCA also agreed that the regulator should monitor firms' assessment of whistleblowing reports, and said it would implement this through changes to its supervisory approach.[176] The FCA did not, however, believe it was its role to require firms to pay compensatory payments to whistleblowers in cases where they had not been properly treated. It noted:

> We support the principle behind this recommendation, but do not believe the FCA is the appropriate body to implement it. [...] We believe that an independent body with expertise in employment law would be best placed to implement this recommendation.[177]

166. Lord McFall of Alcluith, a former Commissioner, tabled an amendment to the Banking Reform Bill to provide for the FCA to be able to require firms to compensate whistleblowers for mistreatment. During debate on the third day of Lords Committee, Lord Newby, speaking for the Government, rejected this proposal:

> In the summer, the Government launched a call for evidence on the whistleblowing framework to see whether there was a case for reforming the law protecting whistleblowers. This will be able to take account of submissions from the financial

173 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, paras 23–26

174 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 14

175 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 28

176 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 29

177 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 30

> services regulators as well as from other interested parties. The call for evidence closes on 1 November and, once the evidence has been assessed, the Government will consider what if any action needs to be taken. It would not be sensible to prejudge the outcome of the call for evidence and implement changes without first looking at all the evidence available to support any changes. Moreover, the Government do not think that it would be appropriate to have different laws or protections for whistleblowers in different sectors. It would not be right to suggest that whistleblowers were more deserving of protection in some sectors than in others.
>
> Finally, this power does not seem consistent with the role and competence of the financial services regulators. There is a comprehensive system of protection for employees in employment law, which applies across the board, protecting workers in every sector. It provides a route of redress using employment tribunals for individuals who have suffered a detriment or dismissal as a result of blowing the whistle.[178]

167. Lord Lawson responded that the amendment was not simply intended to capture mistreatment in which whistleblowers were dismissed:

> It is well documented that what happens normally is not that the whistleblower is dismissed—then, of course, there is the protection of employment law—but that he is stuck in that job and will never ever have any further promotion. I may be wrong, but I do not think there is any redress under employment law for that.[179]

168. Lord Newby replied:

> to the extent that there is or is not redress for that, the review which is under way will be looking at that element of the system as well as everything else. The evidence submitted, including by those who are keen to see the law changed and strengthened in that respect, will be able to take account of all that.[180]

169. The Government's final response to the consultation, however, contained no provision to secure compensation for whistleblowers without recourse to an employment tribunal, proposing instead measures:

> intended to facilitate a culture change in this area and stop whistleblowers being victimised and marginalised in the first instance with employers being more receptive to whistleblowers.
>
> For those who still find themselves in the position where they have suffered a detriment as a result of blowing the whistle and have to make a claim at an [Employment Tribunal (ET)], the Government would expect that in relation to the fees required to bring the claim at ET, a successful claimant should be reimbursed by the respondent by order of the ET. This remains at the discretion of the ET judge and

178 HL Deb, 23 October 2013, col 1084

179 HL Deb, 23 October 2013, col 1084

180 HL Deb, 23 October 2013, col 1084

> a number of other factors may influence this decision, however, we expect that most ETs will apply this practice.[181]

PRA to require firms to operate consistent with safety and soundness principles

170. The PCBS concluded that there could be tension between the obligations of banks' directors to shareholders under the Companies Act 2006 and banks' financial safety and soundness. It recommended that the following should apply to banks above the ring-fence threshold.

- the UK Corporate Governance Code be amended to require directors of banks to attach the utmost importance to the safety and soundness of the firm and for the duties they owe to customers, taxpayers and others in interpreting their duties as directors;
- the PRA Principles for Businesses be amended to include a requirement that a bank must operate in accordance with the safety and soundness of the firm and that directors' responsibilities to shareholders are to be interpreted in the light of this requirement;
- the responsibilities of Senior Persons who are directors include responsibilities to have proper regard to the safety and soundness of the firm; and
- the Government consult on a proposal to amend section 172 of the Companies Act 2006 to remove shareholder primacy in respect of banks, requiring directors of banks to ensure the financial safety and soundness of the company ahead of the interests of its members.[182]

171. The Government supported the PCBS's recommendations in respect of the PRA's Principles for Business and the SMR:

> The Government strongly agrees that bank directors must maintain an awareness of their responsibility to safeguard the security and stability of their firm. The Government fully accepts the need for changes that will have a real impact on bank directors' behaviour, and which will support a focus on stability and soundness, for example by giving directors specific duties under the proposed Senior Persons Regime. The Government therefore supports this recommendation and would encourage the PRA to reflect this in the proposed Senior Persons Regime and the PRA's Principles for Business. In addition, changes to introduce new criminal sanctions for recklessness will further sharpen directors' focus on their personal responsibilities and duties in respect of the firm.

However, it offered more qualified support for the other recommendations:

> Changing directors' duties for directors in banks over the ring-fence threshold has the merit of signalling clearly that shareholders' interests do not overrule the long

181 Department for Business Innovation and Skills, *Whistleblowing framework call for evidence, Government response*, June 2014, p 20

182 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 708

> term safety and soundness of the firm. But it may also have drawbacks. The enforcement of directors' duties is entrusted to shareholders or (new) directors. As the Commission notes, prior to the financial crisis many shareholders were not as effective as they could have been in challenging bank practices. It is consequently not clear that such a change to the duties would be effectively enforced.
>
> What the crisis has shown is that the current regime for enforcing existing directors' duties in the banking sector has had an insufficient deterrent effect on bank directors' behaviour, and thereby failed to protect the public from harm. The Government will therefore seek views both on the Commission's specific recommendation as well as alternative options to strengthen the enforcement regime. Any recommendations for changes to the FRC's Corporate Governance Code would be contingent on the outcome of these deliberations.
>
> As these issues potentially go beyond the financial services sector, the Government will seek views on all of these options in its forthcoming discussion paper on Trust and Transparency, which will be published before summer recess.[183]

The Government published its conclusions on this discussion paper on 16 April 2014. It decided not to propose to amend the directors' general statutory duties to introduce a primary duty for bank directors to promote financial stability over the interests of their shareholders:

> We have considered carefully the PCBS' concerns that a director's duty to promote the success of the company under the Companies Act 2006 could conflict with the financial stability of banks. The directors' duties already explicitly require directors to have regard to a range of matters in the long term, and as the PRA have set out in their response to the PCBS, would not override any obligations to comply with sector-specific requirements. We have separately agreed to a number of the PCBS' recommendations focussed on the accountability of bank directors, including introducing a new Senior Managers regime for bank directors and other key staff, and we will pursue the measures [...] to increase the effective interactions between the enforcement of sector regulation and company law. In this context and based on the views we heard, the Government believes that directors' general statutory duties should continue to apply economy-wide and remain unchanged.[184]

172. The Government did not respond to the PCBS's proposal to remove shareholder primacy from the Companies Act in respect of banks. The PRA said in its response, however, that:

> The PRA does not believe that a director's duties under the current Companies Act would override his or her obligations to comply with relevant PRA requirements. To

183 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, paras 3.26–3.29

184 Department for Business, Innovation and Skills, *Transparency and Trust: Enhancing the transparency of UK company ownership and increasing trust in UK business, Government response*, April 2013, para 258

emphasise this, the PRA will consult on a requirement that a firm must operate in a way which is consistent with its safety and soundness.[185]

173. In January 2014 the PRA consulted on a new set of 'Fundamental Rules', the combined effect of which was, it claimed, to make clear that a bank should operate in a way consistent with safety and soundness, as recommended by the PCBS:

> This chapter sets out the PRA's proposal to replace the six Principles for Businesses (the Principles) inherited from the FSA with the Fundamental Rules (FRs). These new rules will apply to all PRA firms (subject to legal restrictions), irrespective of size and business carried on. The exceptions to the application of the Principles are currently shared and therefore relate to the Principles for Businesses of both the PRA and FCA. These have been amended to reflect that the FRs only relate to prudential matters.
>
> Alongside the approach documents and Threshold Conditions (TCs), the FRs will be core to the PRA's supervisory approach and will be used to structure the Rulebook. The FRs amend the substance of the Principles and contain new rules which aim, collectively, to be an expression of the PRA's general objective of promoting the safety and soundness of regulated firms. The Parliamentary Commission on Banking Standards (PCBS) recommended that the Principles should be amended to include a requirement that a bank must operate in accordance with the safety and soundness of the firm and that directors' responsibilities to shareholders are to be interpreted in the light of this requirement. The combined effect of the proposed FRs address the PCBS recommendation that Principles include safety and soundness.[186]

A role for former senior bankers?

174. The PCBS concluded that it had:

> [...] found the advice and evidence of some experienced bankers untainted by recent crises extremely helpful in exposing the flaws that we have identified in the banking industry and in proposing remedies. The Commission recommends that the PRA and FCA give consideration as to how best they can mobilise the support and advice from the accumulated experience of former senior management in the banking industry.[187]

175. The FCA response was:

> We recognise the importance of utilising the experience of former senior management from the banking industry. We currently employ six senior advisors from industry and plan to increase these numbers. We also use ad-hoc advisors on specific issues. We propose to give further consideration to how we utilise these

185 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, 7 October 2013, para 22

186 Prudential Regulation Authority Consultation Paper CP2/14, *The PRA Rulebook*, January 2014, paras 3.1 and 3.2

187 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–II/HC 175–II, para 991

> individuals, and to how we can attract a diverse mix of experienced executives from the industry to support the FCA in achieving its statutory objectives.[188]

The PRA similarly said that "To support the implementation of this approach in relation to all firms it regulates, the PRA employs senior advisors with extensive industry experience." The Chancellor said to Mr Tyrie that:

> Both regulators already have Senior Advisers who draw on their significant experience as senior executives in the financial services industry and provide an internal consultancy service, giving insight and guidance on market trends, firms, policy, procedures, staff development and other issues on which their input is asked.[189]

176. The Chief Executive of the PRA wrote to Mr Tyrie in March 2014 rejecting the PCBS's recommendation:

> I gave this recommendation careful consideration last year especially bearing in mind that the PRA employs Senior Advisors and has independent Non-Executive Directors on its board.
>
> The PRA board acts as the decision maker for the most significant supervision decisions. You will appreciate this is very different from the FSA board where supervision was not part of the day to day activity of the board. Our senior advisors provide independent challenge to supervisors at all stages of the supervision approach as well as more informal advice and mentoring to supervisors on a regular basis. I believe that this approach is better placed to provide the continuous independent challenge and advice supervisors need than the necessarily periodic meetings a panel or forum would entail.
>
> Senior Advisors in the PRA are drawn from ex-bankers and insurers who have operated on the board or at very senior levels during their executive careers. Currently there are six advisors.
>
> Whilst I fully understand the spirit of your idea to set up a forum, I do not believe that such an approach would supply the amount of exposure to senior people for supervisors that is needed. Actively engaging on a continual basis with independent and experienced Senior Advisors is the best way of supporting and challenging the PRA supervisory approach.[190]

Separate set of regulatory accounts for banks

177. The PCBS considered the case for a separate accounting regime for banks, and concluded that:

> While we recognise the risk of ever more complex and burdensome accounting requirements, flaws in IFRS mean that the current system is not fit for regulators'

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188 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 40

189 Letter from Chancellor of the Exchequer to Andrew Tyrie MP, 10 January 2014

190 Letter from Andrew Bailey to the Chairman of the Treasury Committee, 31 March 2014

purposes. The Commission recommends that non-EU mandated regulatory returns be combined, with any other accounting requirements needed, to create a separate set of accounts for regulators according to specified, prudent principles set by the regulator. This second set of accounts should be externally audited and the Commission recommends that a statutory duty to regulators be placed upon auditors in respect of these accounts. Where there is a public interest for these accounts to be published, the regulator should have a legal power to direct that they (or where appropriate, abbreviated accounts) are included in the financial statements, alongside a reconciliation to the IFRS accounts.[191]

178. The Government response to the PCBS referred this matter to the PRA:

> The Commission further suggests a proposal to require certain financial institutions to provide to regulators additional audited financial reports prepared on an alternative basis. While it may be argued that a parallel, more conservative, accounting regime for banks would mitigate some of the risks in the financial system, this needs to be balanced against the increased costs imposed by introducing a requirement for an additional parallel set of accounts.
>
> The Government will therefore ask the PRA, working with the FPC and the banks, to review the nature and scope of information required to create a separate set of accounts for regulators and bring forward recommendations. This report will need to take a view on the costs and benefits of its production, including with regards to auditing this information on a mandatory basis, and on the need for a new statutory duty in this respect. This review should also include recommendations on the metrics and models used to measure profitability for remuneration purposes.[192]

179. The Bank of England had not at the time of its own response in October 2013 made that judgement:

> In line with the Report's recommendation, the Government has asked the PRA, working with other authorities including the FPC and the banks as appropriate, to review the nature and scope of information required to create a separate set of accounts for regulators and bring forward recommendations. In doing so, the PRA will take account of the costs and benefits of such an initiative, and also the international requirements that increasingly shape the regulatory environment: from 2014, for example, the new CRD IV regulatory reporting regime will form the basis of nearly the entire prudential dataset. We will also consider the Report's recommendations on the metrics and models used to measure profitability for remuneration purposes (34) and on auditors' commentary on subjective matters of valuation, risk and remuneration in their reports on banks' accounts (99).[193]

191 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, [Changing banking for good](), HL Paper 27–II/HC 175–II, para 1039

192 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, paras 5.62–5.63

193 Bank of England, *Bank of England response to the Parliamentary Commission on Banking Standards*, 7 October 2013, para 35

The FCA said in its own response that it would support the PRA's review.[194]

180. The matter was raised at Committee stage in the House of Lords during the passage of the Financial Services (Banking Reform) Bill, when the former Commissioner, Lord Lawson, spoke to an amendment which would have required the preparation of a separate set of accounts in accordance with rules to be made by the PRA and FCA. The minister, Lord Eatwell, opposed the idea, saying:

> The Government have been clear that the crisis highlighted deficiencies in accounting standards and the fact that there was room for improvement. We all agree with that, and that is what we said in our response to the final banking standards report. The regulators must have the information they need to do the job of safeguarding financial stability, and in some instances that may require disclosure of financial information on a basis different from that used by other audited bodies. In response to the noble Lord, Lord Hollick, the PRA will have access to management accounts, for example.
>
> In response to the banking standards report, the Government asked the PRA, working with other authorities and the FPC, to undertake a broad-based review of this subject. That review will take account of the nature and scope of information required to create a separate set of accounts, the costs and benefits of the initiative, and international requirements. From 2014, the new Capital Requirements Directive IV will require banks to disclose supplementary information which goes beyond the international financial reporting standards. Therefore, it is not yet clear whether we need an additional, separate set of accounts in the light of the extensive prudential and other regulatory reporting requirements that are being imposed through the CRD IV framework.
>
> However, I can assure noble Lords that, whatever the outcome of this review, the powers that have been given to the regulators under the Financial Services and Markets Act, as amended in 2012—this, again, goes back to my noble friend asking about the existing powers—are already sufficient to permit the regulators to do everything that this amendment gives them the power to do. Their current powers would permit the regulators to make rules requiring banks to prepare additional accounts, to the extent that this is permissible under EU law, to specify the principles that should govern the preparation of such information and to make it public. To the extent that the amendment merely gives the regulators the powers they already have and does not require anything else of them, it is unnecessary.[195]

181. In a letter on 10 January to Mr Tyrie, the Chancellor reiterated that:

> The Government agrees that regulators must have access to the information they need to carry out their duties effectively. In response to the recommendations by the Commission that this could be achieved through non-EU mandated regulatory returns being consolidated into a separate set of accounts, the Government asked the

194 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 38

195 HL Deb, 23 October 2013, col 1021–2 [Lords Chamber]

PRA to work with other authorities to review the nature of information required to achieve this and to bring forward recommendations.

The PRA agreed to review this proposal while taking into account the new EU-mandated regulatory returns of the new Capital Requirements Regulation (CRR), which will make considerable changes to the current regulatory reporting framework.[196]

182. In March 2014 the Bank of England said that:

Work on this recommendation has been underway since Summer 2013 (including clarifying that there are no major legal constraints). Based on work undertaken, we are now starting to map out a timeline to deliver a consultative document. We expect consultation to start in Q3 2014 and work to complete before year end.[197]

Basic bank accounts

183. The major banks were urged by one of the PCBS's recommendations to demonstrate movement on the issue of basic bank accounts:

The Commission believes that banking the unbanked should be a customer service priority for the banking sector. It should be a right for customers to open a basic bank account irrespective of their financial circumstances. The Commission expects the major banks to come to a voluntary arrangement which sets minimum standards for the provision of basic bank accounts. The failure of the most recent industry talks and the apparent unwillingness of some banks to engage constructively in coming to an agreement is a cause for concern. These standards should include access to the payments system on the same terms as other account holders, money management services and free access to the ATM network. A withdrawal of free access to ATMs would constitute evidence of a race to the bottom. The industry should also commit to a guarantee that an individual satisfying a clearly-defined set of eligibility criteria will not be refused a basic bank account. Such an agreement should outline how minimum standards are to be upheld and updated in the light of technological change; how the right to a basic bank account should be promoted to the public, and particularly the unbanked; and how the obligation to provide basic bank accounts should be distributed between providers. Greater consistency of approach between banks and greater cooperation between them should enable a more cost-effective service to the providers than is possible with the current patchwork of individually designed schemes. In the event that the industry is unable to reach a satisfactory voluntary agreement on minimum standards of basic bank account provision within the next year, the Commission recommends 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.[198]

The PCBS also recommended that:

196 Letter from Chancellor of the Exchequer to Andrew Tyrie MP, 10 January 2014

197 Bank of England progress update on PCBS recommendations, 18 March 2014, p 17

198 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 43

> the agreement, voluntary or not, is underpinned by a requirement on the FCA to uphold minimum standards. [...] If the FCA does not currently have sufficient powers to assume this role, it would need to be given them.[199]

184. The FCA supported the PCBS's intentions in terms of basic bank accounts, and agreed to take them forward with the Government:

> We agree with the importance attached by the Commission to the availability of basic bank accounts, and welcome the recommendation for a voluntary agreement and the Government's commitment to take this forward with industry. Once the Government has completed its discussions with the industry, we will consider these proposals with them.[200]

185. In its response to the PCBS, the Government claimed to be "committed to improving access to financial services for individuals", and said it was "taking forward discussions with the banking sector" and would "provide further details later this year"—that is, in 2013.[201] The Government has not yet reported on its progress.

RBS good/bad bank split

186. The PCBS's final report considered how the Government should deal with its majority holding in RBS. It concluded that the Government should consider the case for putting 'bad' RBS assets in a separate legal entity—a so-called 'good bank/bad bank' split:

> The Government's strategic priority for RBS must be to create strong and competitive provision of its core services, including UK retail and corporate lending, freed from its legacy problems. This is essential, not just for the SME and retail sectors that RBS primarily serves, but also in the interests of the broader economy as a whole. RBS and the Government claim to share these reflections. However, the Commission doubts that the current proposals will achieve this outcome sufficiently quickly or decisively.
>
> The current strategy for returning RBS to the private sector has been allowed to run for five years. Progress has been made but it is time to look at this afresh. The case has been put to the Commission for splitting RBS into a good bank and bad bank. There may be significant advantages in doing so, including focusing the good bank on UK retail and commercial banking and, by freeing it from legacy problems, strengthening its ability to lend and making it a more attractive investment proposition which could subsequently be privatised at a good price. However, there are also important questions which need to be answered before such a course of action could be recommended. These questions include:
>
> · The cost and risk to the taxpayer;

199 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, para 45

200 Financial Conduct Authority, *The FCA's response to the Parliamentary Commission on Banking Standards*, October 2013, p 30

201 HM Treasury and Department of Business Innovation and Skills, *The Government's response to the Parliamentary Commission on Banking Standards*, Cm 8661, July 2013, para 4.5

· What assets would go into the bad bank and what would be left behind in the good bank;

· The case for a wider split between retail and investment banking at RBS given the need to change the past culture at the bank;

· The potential State Aid consequences on the shape of RBS of a further injection of state funds in terms of divestments or other involuntary restructuring; and

· Whether or not such a course of action would be capable of returning the good part of the bank to the private sector more quickly than the course currently being pursued by the RBS management.

The Commission did not take extensive evidence on these questions and most can only be answered on the basis of detailed analysis conducted by those with access to the necessary information—namely the Government and RBS. The Commission recommends that the Government immediately commit to undertaking such detailed analysis on splitting RBS and putting its bad assets in a separate legal entity (a 'good bank/bad bank' split) as part of an examination of the options for the future of RBS. We endorse the Treasury Committee's call for the Government to publish its work on a good bank / bad bank split. If the operational and legal obstacles to a good bank / bad bank split are insuperable, the Government should tell Parliament why and submit its analysis to scrutiny.

The Commission envisages that this examination would be published by September 2013 and examined by Parliament. At the same time, the Government should also examine and report to Parliament on the scope for disposing of any RBS good bank as multiple entities rather than one large bank, to support the emergence of a more diverse and competitive retail banking market.[202]

187. The Chancellor agreed to commission an analysis of the case for such a split in his Mansion House speech on 19 June 2013, only a week after the PCBS report was published:

There's no doubt that, despite all the progress of recent years, RBS remains weighed down by too many poor assets—loans issued in the boom that have gone bad and may take a long time to improve.

The question is—do we remove those poor assets from RBS, and set up what's known as a Bad Bank.

This would then enable RBS to focus on the good parts of its business—supporting the British economy and maximising the benefits for the taxpayer.

With hindsight, I think splitting RBS into a Good Bank and a Bad Bank was probably what should have happened in 2008. That is with hindsight.

I wasn't in office.

I didn't suggest it in opposition.

202 Parliamentary Commission on Banking Standards, First Report of Session 2013–14, *Changing banking for good*, HL Paper 27–I/HC 175–I, paras 496–9

> And I'm not criticizing my predecessor who had to act quickly in a desperate situation.
>
> The question before us now is not about what happened then, but what should happened now.
>
> Is taking bad assets that are still weighing down RBS out of the bank altogether the right answer today?
>
> Opinion is divided—some say the disruption isn't worth it; others that it's the only way we'll really restore our banking system to health.
>
> I've always believed the answer for Britain is to confront the difficult decisions, not wish them away.
>
> So I can tell you today that we will urgently investigate the case for taking the bad assets—those mistakes of the past—out of RBS.
>
> We will judge whether this will allow the Bank to focus on its future supporting the British economy.
>
> We will see whether its right for Britain to, in effect, see RBS broken up.
>
> The review will be swift.
>
> It will be conducted by the Treasury with external professional support.
>
> We'll look at a broad range of RBS's assets, but particularly assets in Ulster Bank and UK commercial real estate.
>
> We're not prepared to put more taxpayer capital into RBS as part of this process.
>
> We will establish a Bad Bank if it meets our three objectives: if it supports the British economy; if it's in the interests of taxpayers—and if it accelerates the return to private ownership.
>
> But if the review reveals that it would not achieve these things, then we won't do it.
>
> We want to get on with this, so we'll conclude the review and make a decision this autumn.[203]

188. The Government commissioned Rothschild and Blackrock Solutions to assist with its review, and its conclusions were published on 1 November 2013. It decided against an external bad bank, instead opting for what it called an 'internal' bad bank:

> The RBS internal bad bank will hold £38 billion legacy assets—representing £116 billion in Risk-Weighted Assets—and will target wind-down within three years, with 55 to 70 per cent delivered within two years. This will rapidly and efficiently de-risk RBS's balance sheet, cementing the shift in RBS's focus from 'rescue' to 'recovery' and allowing RBS to focus on the future, rather than the past.

203 Speech by Chancellor of the Exchequer, Rt Hon George Osborne MP, Mansion House, 19 June 2013

[...]

The Review's conclusion is that, while an external bad bank could deliver some benefits against the Government's three objectives [accelerating its return to the private sector; supporting the British economy; and getting best value for the taxpayer], these effects are likely to be marginal as well as highly uncertain.

It could, in theory, modestly and temporarily boost the valuation of RBS, and would have a relatively small positive impact on RBS's capital position in a stress case, which might impact on the bank's willingness to lend in some circumstances. However, against these potential benefits must be weighed the very considerable practical, operational and financial challenges of executing a taxpayer-funded external bad bank; the extension of the taxpayers' exposure; and the inevitable distraction of RBS management.

Rothschild has advised the Government that:

- the creation of a taxpayer-funded external bad bank would do more harm than good to RBS, as it would not contribute to a capital improvement, would distract management and would involve significant implementation challenges. It would, therefore, detract from meeting the Government's objectives; and

- returning RBS to the private sector will be best helped by letting the new management focus on their UK strategy and not imposing further complex structural change on the bank.[204]

204 HM Treasury, *RBS and the case for a bad bank: the Government's Review*, 1 November 2013, pp 7 and 8

Formal Minutes

Tuesday 28 October 2014

Members present:

Mr Andrew Tyrie, in the Chair

Steve Baker
Stewart Hosie
Mr David Ruffley
Alok Sharma
John Thurso

Draft Report (*Implementing the recommendations of the Parliamentary Commission on Banking Standards*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 188 read and agreed to.

Resolved, That the Report be the Seventh Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for publication on the internet.

[Adjourned till Wednesday 29 October at 2.30 pm

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 475
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the Monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725
Twenty-sixth Report	Financial Conduct Authority	HC 1574
Twenty-seventh Report	Accountability of the Bank of England: Response from the Court of the Bank	HC 1769
Twenty-eighth Report	Financial Conduct Authority: Report on the Governments Response	HC 1857
Twenty-ninth Report	Closing the tax gap: HMRC's record at ensuring tax compliance	HC 1371
Thirtieth Report	Budget 2012	HC 1910

Session 2012–13

First Report	Financial Services Bill	HC 161

Second Report	Fixing LIBOR: some preliminary findings	HC 481
Third Report	Access to cash machines for basic bank account holders	HC 544
Fourth Report	Appointment of Mr Ian McCafferty to the Monetary Policy Committee	HC 590
Fifth Report	The FSA's report into the failure of RBS	HC 640
Sixth Report	Appointment of John Griffith-Jones as Chair-designate of the Financial Conduct Authority	HC 721
Seventh Report	Autumn Statement 2012	HC 818
Eighth Report	Appointment of Dr Mark Carney as Governor of the Bank of England	HC 944
Ninth Report	Budget 2013	HC 1063

Session 2013–14

First Report	Appointments of Dame Clara Furse, Richard Sharp, and Martin Taylor to the Financial Policy Committee	HC 224
Second Report	Appointments of Dr Donald Kohn and Andrew Haldane to the Financial Policy Committee	HC 259
Third Report	Spending Round 2013	HC 575
Fourth Report	Re-appointment of Professor Stephen Nickell to the Budget Responsibility Committee	HC 688
Fifth Report	Appointment of Sir Jon Cunliffe as Deputy Governor of the Bank of England	HC 689
Sixth Report	Re-appointment of Dr Martin Weale to the Monetary Policy Committee	HC 313
Seventh Report	Money Advice Service	HC 457
Eighth Report	OBR Fiscal Sustainability Report 2013	HC 958
Ninth Report	Autumn Statement 2013	HC 826
Tenth Report	Private Finance 2	HC 97
Eleventh Report	Appointment of Spencer Dale to the Financial Policy Committee	HC 1236
Twelfth Report	Appointment of Andy Haldane to the Monetary Policy Committee	HC 1235
Thirteenth Report	Budget 2014	HC 1189

Session 2014–15

First Report	Appointment of Dr Ben Broadbent as Deputy Governor of the Bank of England	HC 205
Second Report	Appointment of Professor Kristin Forbes to the Monetary Policy Committee	HC 206
Third Report	Appointment of Dr Nemat Shafik as Deputy Governor of the Bank of England	HC 492
Fourth Report	Appointment of Anthony Habgood as Chairman of the Court of the Bank of England	HC 451
Fifth Report	Re-appointment of Graham Parker to the Budget Responsibility Committee	HC 580
Sixth Report	Project Verde	HC 728
Seventh Report	Implementing the recommendations of the Parliamentary Commission on Banking Standards	HC 768