Client Alert

July 11, 2013

Changing Banking for Good or for Better?

Introduction

The UK Parliamentary Commission on Banking Standards (the "Commission") published its much anticipated report (the "Report")[1] on 19 June 2013 entitled "Changing Banking for Good". The Government provided its response (the "Response")[2] to the Report on 8 July 2013, stating that it agrees with the principal recommendations of the Report. It states, however, that there are certain recommendations that require more detailed work to ensure effective implementation, and other recommendations that the Government disagrees with, but intends to achieve the goals of the Commission in other ways. The implementation of the recommendations in the Report will change banking in the UK permanently; the question remains whether they will change banking for the better.

The Commission, chaired by Andrew Tyrie MP, was established in July 2012 following the very public recent controversies affecting banks, including issues arising from the setting of the LIBOR rate, to make recommendations regarding improving the culture, professional standards and governance of banks. The Report contains proposals which fall into five main categories:

- increasing individual responsibility at senior levels within banks;
- reforming bank governance to reinforce each bank's responsibility for its own safety;
- creating better functioning markets through increased competition and increased consumer protection;
- reinforcing the responsibilities and importance of regulators, encouraging them to use their judgment more rather than mechanical "box-ticking"; and
- highlighting the responsibilities of the Government, and future Governments and parliaments.

In his speech at Mansion House[3] on the same day of the Report's release, the Chancellor of the Exchequer, George Osborne, called it "very impressive", despite disagreeing with certain recommendations. The Report stresses that there is no single solution that will reform the culture within banking and contains a package of measures that is intended to seek to address matters that the Commission believes contributed to the failure of

[1] The Report may be found at: http://www.parliament.uk/bankingstandards.
[2] The Government's Response to the Report may be found at: https://www.gov.uk/government/publications/the-governments-response-to-the-parliamentary-commission-on-banking-standards.
[3] A transcript of the Chancellor's speech may be found at: https://www.gov.uk/government/speeches/speech-by-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-mansion-house-2013.

banks during the financial crisis. These include a focus on individual accountability at senior levels within banks, seeking reform of compensation through realigning the incentives of staff with the long-term profitability of banks and seeking an emphasis on a greater exercise of judgment by regulators coupled with greater engagement with banks and understanding of their businesses rather than mechanical data collection and box ticking. The recommendations also include more controversial measures such as the proposal for a new criminal offence (and associated custodial sentence) of reckless misconduct for senior bankers.

Individual Responsibility for Senior Bankers

A new senior persons regime and licensing regime

The Report recommends the replacement of the "significant influence" function of the current approved persons regime with a new "senior persons" regime under which specific responsibilities are assigned to key senior individuals who are explicitly informed of their responsibilities. This proposal is aimed at making accountability and enforcement for breach of such duties more effective. The new senior persons regime would cover a narrower range of individuals, so that it would be limited to those who are the key decision-makers in a bank, with other senior staff subject to a separate licensing regime. The new senior persons regime would seek to ensure that senior bankers will not be excused from responsibility because they are not directly involved with a particular act or omission. It is proposed that senior bankers subject to the senior person regime are still responsible for their designated functions, even where they have delegated performance of such functions to another staff member and can still be held accountable for a breach of the applicable standards. The Commission anticipates that these measures will be complemented by a change in the focus of regulatory enforcement from a "bottom-up" to a "top-down" approach, whereby there is much greater on focus on the individuals who are exercising responsibility at the highest levels, and directing the strategy and culture of the bank.

The licensing regime would cover senior bank staff whose behaviour could "seriously harm" the bank or its customers. Those covered by the licensing regime would be subject to a set of banking standards rules, developed by the regulators, which would replace the existing matrix of statements of principle and associated codes of practice. The Commission recommends that such rules should be self-contained and easy to read, so that they are easily understood by the bank staff who are subject to them. They should also explicitly reference important aims that are not included in the current statements of principle, such as the fair treatment of customers and the management of conflicts of interest. The Report also recommends that there should be an accompanying obligation on banks to ensure that the relevant employees understand the banking standards and their practical application, with an onus on the banks to instigate disciplinary action as required and to monitor compliance on an ongoing basis, rather than only when things go wrong.

The Commission also recommends reforming the register underpinning the current approved persons regime so that it covers the proposed senior persons regime and the licensing regime. The Commission proposes that the register should contain details of breaches of banking standards or responsibilities and that cross-jurisdictional cooperation is sought to ensure that individuals cannot circumvent sanctions through moving to another country.

Creating a unified professional body

The Commission discusses the possibility of recommending the formation of a unified professional body for banking standards, including setting out proposed milestones if such a body were to be created. However, it notes that the business of banking involves a wide range of activities rather than the core of learning in professions for which a professional standards body would be more effective. Also, the Commission states that there would be a substantial risk of duplication of work between the regulators and such a professional standards body, with the possibility of overlap and costly over-regulation. The Report states that although banks have indicated that they would agree to the creation of a unified professional body, this would only be on the basis of no such overlap, which would mean stripping away powers from regulators. The Commission advises against this, and as it realises that it will take time before any such professional standards body gains credibility, it recommends that preliminary work to establish such a body be started immediately in certain areas that it perceives would benefit most from such an approach, including retail banking, to demonstrate a commitment to higher standards than those required by regulators.

A criminal offence of reckless misconduct

The Commission's most well-publicised, and controversial, proposal is to introduce a criminal offence of reckless misconduct in the management of a bank. The Commission states that such an offence should be limited to persons covered by the senior persons regime and would only be pursued in the most serious of cases, such as where a bank has failed with substantial cost to the taxpayer, lasting consequences for the financial system or serious harm to customers. The offence will allow for claw-back through civil proceedings of remuneration earned during the period, and as a consequence, of the reckless behaviour. The Commission states that swift action is necessary to ensure the timely public disclosure of misconduct and the decision to prosecute should be considered carefully as public disclosure may only be permitted to occur upon the conclusion of any criminal proceedings.

Although the Commission highlights the difficulties of conviction in such an offence, it indicates that it could serve to be a credible deterrent for senior banking officials from acting "recklessly". However, the concept of recklessness has been notoriously difficult to define in criminal law jurisprudence with the current requirement being that a person needs to be aware of the risk and that it was unreasonable to take such a risk. In the context of a large financial institution such as a bank, it may prove difficult firstly to establish subjective knowledge and secondly to objectively determine that it was unreasonable in the circumstances of such an institution that such a risk be taken. It is of course in the nature of the business of banks to take risks, so the question marks will lie over where the line will be drawn in relation to which risks are reasonable, and who will determine whether a risk was reasonable. Further, some have pointed out that senior bank officers can still be liable to criminal sanction under existing law, including in relating to fraud, theft, market manipulation and insider trading. Concern has also been expressed that a criminal conviction and custodial sentence for recklessness, as opposed to intent, may be unjustified, and it is expected that any draft legislation for such an offence will be closely scrutinised.

Reforming Bank Governance

Remuneration

The Commission proposes the creation of a new Remuneration Code and remuneration structure for senior persons and licensed bank staff to reward behaviour that promotes the long term success of a bank, rather than what it sees as the current culture of prioritising short-term gain at the expense of excessive risk taking. It should be noted that the current UK Remuneration Code is likely to be revised shortly to reflect new requirements under the revised Capital Requirements Directive ("CRD IV") which is expected to come into effect on 1 January 2014 and which includes bonus caps. Notwithstanding these changes (and previous regulatory restrictions that have already been introduced in relation to executive remuneration), the Commission considers that further reform is necessary. Under the Commission's proposed new Remuneration Code, significantly more remuneration is proposed to be deferred, and for longer, for up to 10 years. This has given rise to concerns that the deferral of remuneration by such a long period will not have an impact on the behaviour of bankers as they will disregard such bonuses, due to their lack of imminence and, together with the caps on bonuses being introduced, this is likely to result in large increases to base salary, greatly increasing banks' fixed costs.

The Commission states in the Report that a key aim of its new proposed Remuneration Code should be to incentivise senior persons and licensed bank staff to prioritise the long-term performance of the bank. It envisages this will include providing deferred remuneration in the form of instruments such as bail-in bonds, which may be written down or cancelled if the bank becomes troubled. The Commission recommends that banks should have powers to cancel deferred bonuses if there is individual or group misconduct or a downturn in the performance of the bank, and also that regulators should have discretionary powers to cancel any unvested pension rights and employment termination benefits where a bank needs to be bailed out by the taxpayer.

Governance structure

The Report highlights the importance of the Chairman and proposes that he should have the direct personal responsibility of overseeing the board of directors, and notes the importance of non-executive directors in ensuring that the risks facing a bank are explored and the board held accountable. The Report also recommends the reform of the nomination process for non-executive directors so as to not sift out those who are likely to challenge the behaviour of the directors. The Commission proposes that there should be a discrete risk committee in each bank, chaired by an independent chief risk officer, and clear lines of access and accountability to the board for the heads of the risk, compliance and internal audit committees. The Report asserts that the responsibility for acting in accordance with the letter and spirit of regulation should lie with every individual in a bank.

Shareholders

The Commission recommends that the Government should consult on a proposal to amend section 172 of the Companies Act 2006 to require directors of a bank to prioritise the financial safety and soundness of the bank, and the interests of its customers above the interests of its shareholders. The Report also promotes a more active role for institutional shareholders, who it believes should encourage bank board members to look to the long term, rather than being “mesmerised” by short-term profit, and thus consider the safety of their clients’ investments.

Whistleblowing

The Report also recommends the creation of a framework for, and the encouragement of, whistleblowing, so that staff are not afraid to make appropriate notifications in relation to poor standards or risky activities within a bank, so as to enable earlier intervention where problem areas arise. It suggests that the Chairman, as an independent non-executive director, should be responsible for this function.

Better Functioning Markets

The third theme of the Commission’s recommendations involves improving the competitiveness of the UK banking market. It recommends that the promotion of competition should be an express objective of the recently formed Prudential Regulatory Authority (“PRA”) (one of the successors to the Financial Services Authority, along with the Financial Conduct Authority (“FCA”)), rather than the PRA merely being obliged to “have regard to” competition in the fulfillment of its responsibilities as the prudential regulator. The Report recommends that the new Competition and Markets Authority (“CMA”), to be launched in April 2014, investigate competition in the retail and SME banking sectors. George Osborne announced in his Mansion House speech that the Office of Fair Trading has brought forward its review of competition in the SME sector and that he has asked it to investigate the extent to which the new challenger banks created by the breaking up of Lloyds Banking Group (“Lloyds”) and The Royal Bank of Scotland (“RBS”) will strengthen competition in that sector.

The Report also recommends that the Government should establish a panel to investigate improving personal bank account portability, so customers can switch their accounts between banks and retain their account number. Further, it states that banks should focus on “banking the unbanked”, regardless of their personal financial circumstances, and agree on minimum standards for the provision of basic bank accounts, *e.g.* agreeing not to charge for cash withdrawals from ATMs.

The Role of Regulators

Regulators to use more judgment

The Report concludes that regulatory compliance during the pre-crisis period focused on the detail of rules and procedures rather than looking at the overall picture and thus regulators missed the systemic risks which caused the greater losses, and were slow to respond to the crisis. The Commission therefore believes that senior regulatory staff should use judgment rather than just blindly relying on procedures. Also, they should take direct personal responsibility for engaging with senior staff at banks, for example by going along to certain board meetings, so that there is a free flow of information between banks and regulators. It believes this will allow regulators to act more swiftly, on the basis of real-time information rather than acting later with the benefit of hindsight.

Enforcement

The increased importance of enforcement by regulators in the recommendations from the Commission complements the increased emphasis on individual and entity-level responsibility. The Commission recommends the imposition of the full range of civil penalties, including a potential ban, on senior bank employees whose banks are subject to successful enforcement action, together with a reversal of the burden of proof, so that the onus is on such individuals to prove that they took all reasonable steps to prevent or mitigate the effects of a specified failing.

The Commission floated the idea of creating a new statutory body for enforcement in the banking sector but instead limited itself to recommending the creation of an autonomous body, the Regulatory Decisions Committee ("RDC") within the FCA to assume the role of making relevant enforcement determinations for both the PRA and the FCA. The Commission recommends that the RDC's composition should change so that it is chaired by a person with senior judicial experience and should have a lay (non-banking or financial services professional) majority but also contain several members with extensive senior banking experience.

Special measures

The Report also proposes a new tool known as "special measures", as a pre-cursor to enforcement action, if regulators have cause for concern in relation to a particular bank meeting its standards and responsibilities. The tool allows for the PRA and the FCA to notify the relevant bank of its failings, and give it a reasonable opportunity to explain itself before commissioning an independent report and then formally committing the bank to rectification measures, as required. As indicated further below, the Government's Response states that it believes the Commission's aims can be achieved under existing powers without the need for new legislation.

Aligning tax rules with regulatory objectives

The Commission also expresses concern that tax rules are misaligned with regulatory objectives in that they reward banks for financing their activities through debt rather than equity (*e.g.* through the tax deductibility of interest payments on debt), thereby increasing leverage and disincentivising banks from holding capital in the form of equity. The Commission believes that removing this bias could address the misalignment and contribute to greater financial stability. It is suggested this may be achieved through allowing banks to obtain the equivalent of a tax deduction for payments to equity, offset by an increase in the bank levy.

Responsibilities of the Government and Parliament

The Commission recommends that UK Financial Investments Limited ("UKFI"), which owns the Government's shareholdings in RBS and Lloyds, be dissolved, since its view is that the Government has interfered in the affairs of such banks, either directly or through using UKFI as its proxy, undermining the aim that the Government should not be involved in the day to day management of the banks, particularly RBS. Rather than seek to ensure the independence of UKFI, which the Commission thinks is unrealistic, it believes UKFI should be absorbed back into HM Treasury. In his Mansion House speech, George Osborne disagreed with the Commission in relation to the dissolution of UKFI, stating that it plays an important role in ensuring the Government's shareholdings were managed on an "arm's-length" basis. As indicated below, this is consistent with the position taken in the Response. He also stated that the Government is committed to ensuring that the taxpayer gets fair value for its shares in RBS and indicated that a Treasury review would be undertaken to decide whether RBS should be split into a "good bank" and a "bad bank", as explored by the Report. Both the Commission and the Chancellor note that Lloyds, as a less politically complex situation, is closer to being exited than RBS, which still needs to improve profitability and lending before the Government will sell its shareholdings.

The Commission states that it is disappointed at the Government's decision not to let the Financial Policy Committee ("FPC") of the Bank of England determine the leverage ratio for banks. The FPC, which was set up along with the PRA and FCA, is responsible for the stability and resilience of the financial system as a whole, and the Commission believes it is better placed to make such a decision than politicians. The Commission also states its view that the current minimum ratio of 3% should be set significantly higher. Further, the Report recommends that to reach the leverage ratio, banks should be obliged to increase absolute capital levels rather than reducing lending.

The Report highlights that the new, complex financial services regulatory structure introduced by the Financial Services Act 2012 needs accompanying accountability mechanisms, to ensure that the actions of regulators are scrutinised appropriately by Parliament. Further it states that the Government should support the regulators and resist opposition to regulation on the basis that the existing reforms will be enough or that stronger regulation damages the City's competitiveness and brings with it the threat of bank relocation, as improving the safety and soundness of banking will benefit the City in the long term. However, it remains to be seen whether the costs of compliance with any regulations implemented as a result of these recommendations will outweigh any benefits, and whether there will be any unintended consequences as a result of the interrelationship between these and existing reforms.

The Government's Response

In its Response, the Government asserts that it agrees with all of the Commission's principal recommendations and plans to implement, amongst others, the proposals relating to the introduction of the new senior persons regime for senior bank staff, new banking standards rules, reversing the burden of proof for senior persons, corporate governance and bonus composition, deferral for up to ten years and claw-back of bonuses for misconduct and additional remuneration, such as unvested pension benefits and loss of office payments where banks receive a taxpayer bailout. The Response also indicates that a criminal offence of reckless misconduct for senior bankers will be introduced, that the PRA will be given a secondary competition objective and that the new payments regulator, once it is set up, will be instructed to urgently examine account portability and payment systems ownership.

Although the Government broadly agrees with the Commission's remuneration recommendations, it notes that further work needs to be done to hone the detailed rules, and asserts that it will liaise with the PRA and FCA to do so. The Government also states that the recommendations relating to the structure and deferral of bonuses should be limited to senior persons and should not include bank employees subject to the licensing regime as such employees would not be considered "Material Risk Takers" under the current European Banking Authority rules. The Government believes that the current rules rightly govern the remuneration of those employees who have a material impact on the risk profile of the bank, in order to ensure financial stability, and that extending the rules to other staff could unfairly affect the pay of junior staff whose actions do not have a material impact on the risk profile of an institution. The Government also notes that the bonus caps introduced by CRD IV may lead to an increase in fixed pay, which cannot be clawed back for misconduct and is not performance related, hence it does not accord with the principle of aligning remuneration with the long-term performance of a firm. Therefore it proposes that the PRA consider the way it should exercise its existing discretion to require that a substantial part of remuneration be deferred for longer where necessary to achieve its aims.

The Government indicates that as the current regime for enforcement of directors' duties has not policed bank directors' behaviour sufficiently, it will hold a consultation on the options to strengthen the enforcement regime, including in relation to the Commission's recommendation for directors of banks to prioritise the "safety and soundness" of the firm over the interests of shareholders. The Response states that the Commission's recommendations in relation to corporate governance will be implemented primarily through the new senior persons regime, the proposed rules in CRD IV and via changes to the Corporate Governance Code, as required. In relation to whistleblowing, the Government states that it will consider the Commission's recommendations in the context of the results of the wider call for evidence that the Whistleblowing Commission[4] aims to publish by the end of the year in order to analyse how a whistleblowing framework could be created and operate in the current employment environment.

Although the Government agrees with the Commission that the PRA should be given a secondary competition objective, it disagrees that the FCA's strategic competition objective should be dropped, as the Government believes that such a strategic objective acts as a "mission statement" to bring together the diverse aspects of the FCA's work. The Government states that it has secured a commitment from the banking industry to introduce a seven-day Current Account Switching Service ("CASS") in September of this year, which will be free to use, redirect payments to the new account for 13 months after switching and comes with a guarantee to protect customers from losing money if there are problems with the switching. The Government has stated that if CASS does not operate to bring about the expected consumer benefits in terms of ease of switching bank accounts, it will consider other options, including full account portability. Further to the Chancellor's statement in his Mansion House speech that the Government would be considering whether it should split RBS into a "bad bank" and a "good bank", the Government states that it will not be doing so, as it would generate significant additional costs, which the taxpayer would ultimately end up bearing. The Response also re-asserts the statement of the Chancellor that UKFI will not be abolished.

The Government welcomes the Commission's concept of placing a bank on "special measures" but believes that this can be implemented under regulators' existing powers, without the need for further legislation. The Government also states that there is no need for an external RDC, as the existing regulatory framework is sufficient and the external RDC would merely be replicating the work of the Upper Tribunal of the judiciary. The Government disagrees with the Commission's recommendation that discussions between regulators and senior executives should be made public, stating that the need for accountability needs to be balanced against confidentiality, and that the risks of records being made public could prevent firms from having open discussions with regulators.

In relation to the Commission's recommendation that the leverage ratio be determined by the FPC, the Government states that it should be determined internationally by Basel III, although once this is done the Government indicates that the FPC will have the power to determine the baseline leverage ratio for investment firms and deposit takers, subject to the Basel III minimum. Although the Government welcomes the idea of tax relief to incentivise banks to use equity financing, it states that this proposal would have a significant impact on tax revenues, and so will be considered as part of the tax review for the 2014 budget.

In Annex A of the Response, the Government lists each of the Commission's recommendations, along with which body will be responsible for implementing it (the Government, the Bank of England, the FCA or the PRA) and whether primary legislation will be required to implement such recommendation. The Government agrees with the Commission that those recommendations in the Report requiring primary legislation should, where necessary, be implemented through amendments in autumn to the Financial Services (Banking Reform) Bill currently being considered by Parliament (the "Banking Reform Bill"). It is also possible that certain of the Commission's proposals in relation to the Remuneration Code may be implemented at the same time as the amendments required by CRD IV referred to above. The Report states that although parliament will monitor the implementation of the recommendations, the banks will have a crucial role to play in instigating changes in their culture, ethos and standards to ultimately restore public trust in the industry.

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[4] The call for evidence of the Whistleblowing Commission, which was launched on 27 March 2013 and closed on 21 June 2013, may be found at: http://www.pcaw.org.uk/whistleblowing-commission-public-consultation.

Likely Impact of Report

Although the Report makes a number of wide-ranging recommendations to reform various aspects of the UK banking industry, it is not yet clear how significant an impact the recommendations will have on UK banks. It should also be noted that there is some overlap between the Report and the recommendations of the UK's Independent Commission on Banking chaired by Sir John Vickers[5], many of which are proposed to be enacted through the Banking Reform Bill. Although the Vickers report principally focused on proposed structural changes to the UK banks including the proposed ring-fencing of retail banking from investment banking, a number of other recommendations were very similar to those set out in the Report, including an increase in the leverage ratio from the Basel III minimum of 3% and the need for greater competition in the UK banking industry. Significant changes have already been made to the remuneration regime for bank employees and, as indicated above, further changes will be necessary to reflect the CRD IV requirements. Whilst the Government is broadly sympathetic to the recommendations of the Commission in relation to remuneration, it will want to ensure that the proposals are broadly consistent with the minimum requirements in the EU so UK banks are not at a material disadvantage to their European competitors.

Most of the Commission's conclusions in relation to the need for regulatory reform and a change in attitude amongst bankers, regulators and politicians are consistent with many of the regulatory reforms already being pursued internationally by the G20 and within the EU. That said, there are specific recommendations in relation to the regulation of bankers and the banking industry that will result in material changes to the regulatory and governance regimes for UK banks. Some concerns have also been raised, that the increased focus on personal responsibility that the recommendations would create may not serve to encourage senior individuals to seek out or take on positions of responsibility, especially, and paradoxically, in organisations with a poor track record, where better leadership is needed. Also, although the proposed criminal offence of reckless misconduct in the management of a bank has attracted many headlines, it is unclear whether this will have a major impact on behaviour and whether the new criminal sanction is likely to be utilised in more than a handful of cases.

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[5] Independent Commission on Banking, Final Report – Recommendations, 16 September 2011.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.