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ENSURING COMPLIANCE?

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We have read about non-compliance by financial firms, in particular with respect to Libor and sanctions. Within domestic regulatory regimes compliance is a perennial issue. From the perspective of this class the examples of non-compliance we have seen raise some specific issues beyond the normal compliance focus: they are transnational, and they do not involve peripheral market participants. The transnational/international nature of the firms subjected to sanctions—firms which carried on business in multiple jurisdictions through subsidiaries and branches—raises some questions about the possibility of effective cross-border supervision. And, as these examples of non-compliance suggest a pervasive and transnational issue with respect to compliance they invite us to think about some of the issues of fixing the culture of finance we have already touched on.

In 2012, the UK established a Parliamentary Commission on Banking Standards to examine the culture of banking.[2] The Commission carried out a wide-ranging review of banking in the UK, was critical of banks, regulators, governments and investors, and made a number of suggestions for reforms. One of these suggestions involves increasing competition in banking (and this idea is currently being implemented in the UK). In part this is to reduce reliance on a small number of institutions (it relates to the too big to fail problem). But what do you think the implications for compliance might be? As you read the excerpt form the Commission's report think whether you agree with the Commission's diagnosis and proposed solutions to the problems it identifies. For example, the Commission seems to think that developing the idea of banking as a profession may be part of the way forward. What do you think of this idea? Does

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[2] Parliamentary Commission on Banking Standards Appointed (Jul. 17, 2012) at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/appointment-of-commission/ . Members of the Commission were: Andrew Tyrie MP, Chairman, Mark Garnier MP, Andy Love MP, Pat McFadden MP, John Thurso MP, Lord Turnbull, Baroness Kramer, Lord Lawson, Lord McFall, and the Bishop of Durham.

the Commission have too much faith in the idea of professional self-regulation? Traditionally the idea of a (learned) profession has involved two main components: knowledge which was not generally available, combined with an expressed commitment to high standards of behavior. In the twenty-first century there are reasons to be skeptical of these two characteristics of professions: professionals are subject to increasing competition from people outside the profession (for example, legal services outsourcing), and in many ways professional activities seem hard to distinguish from business activities which may undermine the idea of high standards. For example, in the US, scholars of the legal profession have thought about how professional self-regulation should be adapted to fit new models of law practice.[3] **Milton Regan** describes law firm ethics as "nested":[4]

... we can conceptualize the components that influence ethical behavior as nested inside one another. The first level is the individual who engages in decision-making, who may receive advice from colleagues who act informally to provide ethical guidance. The second level, which provides the larger context for the first, is a firm's ethical infrastructure, which attempts in various ways to shape and channel that behavior. The third level, which provides the larger context for the first two, is a firm's ethical culture. This can prompt an individual to embrace ethical values to which a firm is committed, which provides intrinsic motivation to comply with the procedures and policies that make up the firm's infrastructure. ... The ethical culture in a law firm thus provides the larger context in which individual action and the firm's ethical infrastructure operate. Ideally, it communicates that a firm is committed to practicing law consistently with the values reflected in the professional responsibilities of lawyers. While this can be crucial in strengthening ethical behavior, there still may be limits to its effectiveness. First, members of an organization are more likely to be receptive to its ethical culture as they identify more with the organization. An expanded sense of identity more closely
aligns individuals' self- interest with that of the organization, so that they see their own success as tied to the success of the larger entity. Prompting this identification, however, can be a challenge for a contemporary law firm. Most firms are extraordinarily fragile, vulnerable to the departure of their most profitable partners in the lateral market. This fragility may make partners feel that it is hazardous to act as if their long-term self-interest is tied to that of the firm. In addition, competitive pressures now prompt many firms to terminate lawyers who are not performing at a level that the firm deems adequate. This heightened vulnerability also can prevent the formation of any deep sense of attachment to a firm.
A second potential limit to the effectiveness of efforts to promote an ethical culture is that when individuals in an organization think of ethics, what tends to come to mind is behavior broader than the type that is focus of an ethics program. For members of an organization, ethics relates most

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[3] *See, e.g.*, Ted Schneyer, *On Further Reflection: How "Professional Self-Regulation" Should Promote Compliance with Broad Ethical Duties of Law Firm Management*, 53 ARIZ. L. REV. 577, 589 (2011) (" Since the vast majority of lawyers in 1908 practiced alone and had few, if any, lay employees, the absence of references to firms or firm governance in the 1908 Canons was hardly surprising. By the 1980s, however, law practice was very different. Two-thirds of the bar practiced in multi-lawyer workplaces, and well over half the lawyers in private practice worked in multi-lawyer firms. Many firms had branch offices, making intra-firm coordination both more difficult and more important. The ratios of associates to partners had also risen markedly, underscoring the need for supervision.And firms were hiring more nonlawyers who required training and supervision, including lay administrators." (Footnotes omitted))

[4] Milton C. Regan,, Jr. *Nested Ethics: A Tale of Two Cultures*, 42 HOFSTRA L. REV. 143 (2013).

prominently to how fairly the organization treats the people who work there. Research indicates that there is a strong connection between this assessment and ethical attitudes and behavior. The greater the perception of fairness, the more credible an organization's professed commitment will be to ethical values and the more successful it will be in prompting its members to identify with it. This directs attention to policies and practices that we may not even think of as relating to ethics. They include matters such as promotion, compensation, and whether people who are generous or selfish tend to get ahead in the organization. These issues relate to the broader culture of an organization, which in turn affects the ability to promote an ethical culture. We therefore can conceptualize organizational culture as an additional component to our model within which the others are nested..

Here is an excerpt from the **Report of the Parliamentary Commission on Banking Standards** :[5]

Our approach

The UK banking sector's ability both to perform its crucial role in support of the real economy and to maintain international pre-eminence has been eroded by a profound loss of trust born of profound lapses in banking standards. The Commission makes proposals to enable trust to be restored in banking. These proposals have five themes:

- making individual responsibility in banking a reality, especially at the most senior levels;
- reforming governance within banks to reinforce each bank's responsibility for its own safety and soundness and for the maintenance of standards;
- creating better functioning and more diverse banking markets in order to empower consumers and provide greater discipline on banks to raise standards;
- reinforcing the responsibilities of regulators in the exercise of judgement in deploying their current and proposed new powers; and
- specifying the responsibilities of the Government and of future Governments and Parliaments.

No single change, however dramatic, will address the problems of banking standards. Reform across several fronts is badly needed, and in ways that will endure when memories of recent crises and scandals fade.

Making individual responsibility a reality

The problem

Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite.

A new framework for individuals

The Approved Persons Regime has created a largely illusory impression of regulatory control over individuals, while meaningful responsibilities were not in practice attributed to anyone. As a result,

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[5] Report of the Parliamentary Commission on Banking Standards, Changing Banking for Good, Vol. 1, HL Paper 27-I, HC 175 -I (Jun. 2013) at http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf

there was little realistic prospect of effective enforcement action, even in many of the most flagrant cases of failure. The Commission proposes a new framework for individuals with the following elements:

- a Senior Persons Regime, which would ensure that the key responsibilities within banks are assigned to specific individuals, who are made fully and unambiguously aware of those responsibilities and made to understand that they will be held to account for how they carry them out;
- a Licensing Regime alongside the Senior Persons Regime, to apply to other bank staff whose actions or behaviour could seriously harm the bank, its reputation or its customers;
- the replacement of the Statements of Principles and the associated codes of practice, which are incomplete and unclear in their application, with a single set of Banking Standards Rules to be drawn up by the regulators; these Rules would apply to both Senior Persons and licensed bank staff and a breach would constitute grounds for enforcement action by the regulators.

Incentives for better behaviour

Remuneration has incentivised misconduct and excessive risk-taking, reinforcing a culture where poor standards were often considered normal. Many bank staff have been paid too much for doing the wrong things, with bonuses awarded and paid before the long-term consequences become apparent. The potential rewards for fleeting short-term success have sometimes been huge, but the penalties for failure, often manifest only later, have been much smaller or negligible. Despite recent reforms, many of these problems persist.

The Commission proposes a radical re-shaping of remuneration for Senior Persons and licensed bank staff, driven by a new Remuneration Code, so that incentives and disincentives more closely reflect the longer run balance between business risks and rewards. The main features of the redesign are as follows:

- much more remuneration to be deferred and, in many cases, for much longer periods of up to 10 years;
- more of that deferred remuneration to be in forms which favour the long-term performance and soundness of the firm, such as bail-in bonds;
- the avoidance of reliance on narrow measures of bank profitability in calculating remuneration, with particular scepticism reserved for return on equity;
- individual claims on outstanding deferred remuneration to be subject to cancellation in the light of individual or wider misconduct or a downturn in the performance of the bank or a business area; and
- powers to enable deferred remuneration to Senior Persons and licensed individuals, as well as any unvested pension rights and entitlements associated with loss of office, to be cancelled in any case in which a bank requires direct taxpayer support.

A new approach to enforcement against individuals

A more effective sanctions regime against individuals is essential for the restoration of trust in banking. The current system is failing: enforcement action against Approved Persons at senior levels has been unusual despite multiple banking failures. Regulators have rarely been able to penetrate an accountability firewall of collective responsibility in firms that prevents actions against individuals. The patchy scope of the Approved Persons Regime, which has left people, including many involved in the Libor scandal, beyond effective enforcement.

The Commission envisages a new approach to sanctions and enforcement against individuals:

- all key responsibilities within a bank must be assigned to a specific, senior individual. Even when responsibilities are delegated, or subject to collective decision making, that responsibility will remain with the designated individual;
- the attribution of individual responsibility will, for the first time, provide for the full use of the range of civil powers that regulators already have to sanction individuals. These include fines, restrictions on

responsibilities and a ban from the industry;
- the scope of the new licensing regime will ensure that all those who can do serious harm are subject to the full range of civil enforcement powers. This is a broader group than those to whom those powers currently extend;
- in a case of failure leading to successful enforcement action against a firm, there will be a requirement on relevant Senior Persons to demonstrate that they took all reasonable steps to prevent or mitigate the effects of a specified failing. Those unable to do so would face possible individual enforcement action, switching the burden of proof away from the regulators; and
- a criminal offence will be established applying to Senior Persons carrying out their professional responsibilities in a reckless manner, which may carry a prison sentence; following a conviction, the remuneration received by an individual during the period of reckless behaviour should be recoverable through separate civil proceedings.

Reforming governance to reinforce individual responsibility

The financial crisis, and multiple conduct failures, have exposed serious flaws in governance. Potemkin villages were created in firms, giving the appearance of effective control and oversight without the reality. Non-executive directors lacked the capacity or incentives to challenge the executives. Sometimes those executives with the greatest insight into risks being added to balance sheets were cut off from decision-makers at board level or lacked the necessary status to speak up. Poor governance and controls are illustrated by the rarity of whistle-blowing, either within or beyond the firm, even where, such as in the case of Libor manipulation, prolonged and blatant misconduct has been evident. The Commission makes the following recommendations for improvement:
- individual and direct lines of access and accountability to the board for the heads of the risk, compliance and internal audit functions and much greater levels of protection for their independence;
- personal responsibility for each individual director for the safety and soundness of the firm and a Government consultation on amending the Companies Act to prioritise financial safety over shareholder interests in the case of banks;
- direct personal responsibility on the Chairman to ensure the effective operation of the board, including effective challenge by non-executives, and on the Senior Independent Director, supported by the regulator, to ensure that the Chairman fulfils this role; and
- individual responsibility for a named non-executive director, usually the Chairman, to oversee fair and effective whistle-blowing procedures, and to be held accountable when an individual suffers detriment in consequence of blowing the whistle.

Better functioning markets

The UK banking sector is not as competitive as it should be. Retail and business customers alike are often denied sufficient choice or access to enough information to exercise effective judgement. Greater market discipline can help address the resulting consumer detriment and lapses in standards, and buttress regulation. Where such remedies can be found they should be deployed. The Commission proposes that:
- the Government immediately establish an independent panel of experts to assess means of enabling much greater personal bank account portability;
- the Treasury examine the tax treatment of peer-to-peer lending and crowdfunding firms to ensure a level playing field with established competitors and review the effectiveness of tax incentives intended to encourage investment in Community Development Finance Institutions;
- the major banks come to a voluntary agreement on minimum standards for the provision of basic bank accounts, including access to the payments system and money management services, and free use of the

ATM network, within 12 months or be subject to a new statutory duty;
- competition be an objective of the PRA, subject to its overriding responsibility for financial stability;
- the Competition and Markets Authority immediately commence a full market study of competition in the retail and SME banking sectors to be completed on a timetable consistent with a Market Investigation Reference by the end of 2015; and
- the Government should immediately announce a process for considering alternative strategies for the future of RBS, including splitting the bank and putting its bad assets in a separate legal entity (a 'good bank / bad bank' split), to report by September 2013.

Reinforcing the responsibilities of the regulators

Serious regulatory failure has contributed to the failings in banking standards. The misjudgement of the risks in the pre-crisis period was reinforced by a regulatory approach focused on detailed rules and process which all but guaranteed that the big risks would be missed. Scandals relating to mis-selling by banks were allowed to assume vast proportions, in part because of the slowness and inadequacy of the regulatory response.

Our proposed emphasis on individual responsibility within banks needs to be matched by the replacement of mechanical data collection and box ticking by a much greater emphasis on the exercise of judgement by the regulators, supported by more effective oversight and empowerment tools. In particular:
- supervisors need to be close enough, and have a detailed enough understanding, of businesses to take swift decisions based on up-to-date information, rather than belated actions with the benefit of hindsight;
- the most senior regulatory staff should be expected to use judgement, rather than relying on procedures, and to take direct personal responsibility for ensuring that their engagement with individual banks, and the CEO, Chairman and the Board in particular, is securing the information required best to assess risk. They should expect to be held accountable, ultimately to Parliament, for this crucial role;
- a new tool proposed by the Commission, "special measures", will provide for the deployment of a broader range of regulatory powers when the FCA and PRA are concerned that systemic weaknesses of leadership, risk management and control leave a bank particularly prone to standards failures;
- regulators need to remove obstacles to a more competitive market in banking, including through steps to support the development of a more diverse banking market;
- regulators should identify the risks to a judgement-based approach from overly prescriptive international rule books and ensure that Parliament is kept fully informed of them; and
- there should be mandatory dialogue between supervisors and external auditors and a separate set of accounts for regulatory purposes.

The responsibilities of Governments and Parliaments

There were many players in the development of the crisis in banking that has unfolded since 2007. The behaviour of bankers was appalling, but regulators, credit ratings agencies, auditors, governments, many market observers and many individual bank customers in their approach to borrowing created pressures in the same, and wrong, direction. Governments have a particular responsibility, many of them having been dazzled by the economic growth and tax revenues promised from the banking sector. Implementing the recommendations of the Commission would signal a fresh approach.

The current Government's particular priorities must include:
- taking swift and decisive action to place RBS in a position where it can make a full contribution to a better functioning market that, in particular, supports lending to businesses;
- ensuring that changes to regulatory objectives entrench a change in regulatory approach towards competition; and

- relinquishing political control over decisions over the leverage ratio, the single most important tool to deliver a safer and more secure banking system, which is properly a matter for regulators.
Future Governments and Parliaments have important roles in ensuring that reform is sustained. In particular, this will mean:
- holding regulators more meaningfully to account for their decisions, while avoiding knee-jerk assumptions either that regulators are acting as an unnecessary constraint on the actions of bankers or that regulators are culpable for every standards failure; and
- resisting the arguments from opponents of reform who will claim that any further change to banking will represent an upheaval too far or that risks have been eliminated and "this time is different".

The banking industry can better serve both its customers and the needs of the real economy, in a way which will also further strengthen the position of the UK as the world's leading financial centre. To enable this to happen, the recommendations of this Commission must be fully implemented in a coherent manner. They complement reforms already proposed by Parliament and by the Independent Commission on Banking. If fully implemented, the proposals of this Commission's Reports can change banking for good...

Banks in the UK have failed in many respects. They have failed taxpayers, who had to bail out a number of banks including some major institutions, with a cash outlay peaking at £133 billion, equivalent to more than £2,000 for every person in the UK. They have failed many retail customers, with widespread product mis-selling. They have failed their own shareholders, by delivering poor long-term returns and destroying shareholder value. They have failed in their basic function to finance economic growth, with businesses unable to obtain the loans that they need at an acceptable price. (Paragraph 1)

Banks have a crucial role in the economy. Banking can make an immense contribution to the economic well-being of the United Kingdom, by serving consumers and businesses, and by contributing to the United Kingdom's position as a leading global financial centre. The loss of trust in banking has been enormously damaging; there is now a massive opportunity to reform banking standards to strengthen the value of banking in the future and to reinforce the UK's dominant position within the global financial services industry. A reformed banking industry with higher levels of standards has the potential, once again, to be a great asset to this country...

The restoration of trust in banking is essential not just for banks. It is essential to enable the industry better to serve the needs of the real economy and to contribute effectively to the UK's role as a global financial centre...

The UK is a global financial centre, but a medium-sized economy. The benefits of being a global financial centre are very important in terms of jobs, investment, tax revenue and exports. In finance, the UK is a world leader. But being a global financial centre with a medium-sized wider economy also poses risks, as was seen in the bail-outs and huge injections of taxpayers' money which took place during the financial crisis. It is essential that the risks posed by having a large financial centre do not mean that taxpayers or the wider economy are held to ransom. That is why it is right for the UK to take measures, some already taken or in prospect, which not only protect the UK's position as a global financial sector, but also protect the UK public and economy from the associated risks....

Banking history is littered with examples of manipulative conduct driven by misaligned incentives, of bank failures born of reckless, hubristic expansion and of unsustainable asset price bubbles cheered on by a consensus of self-interest or self-delusion. An important lesson of history is that bankers, regulators and politicians alike repeatedly fail to learn the lessons of history: this time, they say, it is different. Had the warnings of past failures been heeded, this Commission may not have been necessary.,,,

One of the most dismal features of the banking industry to emerge from our evidence was the striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they presided. Ignorance was offered as the main excuse. It was not always accidental. Those who should have been exercising supervisory or leadership roles benefited from an accountability firewall between themselves and individual misconduct, and demonstrated poor, perhaps deliberately poor, understanding of the front line. Senior executives were aware that they would not be punished for what they could not see and promptly donned the blindfolds. Where they could not claim ignorance, they fell back on the claim that everyone was party to a decision, so that no individual could be held squarely to blame—the Murder on the Orient Express defence. It is imperative that in future senior executives in banks have an incentive to know what is happening on their watch—not an incentive to remain ignorant in case the regulator comes calling....

The professions may not be paragons, but they do at least espouse a strong duty of trust, both towards clients and towards upholding the reputation of the profession as a whole. In contrast, bankers appear to have felt few such constraints on their own behaviour. Few bankers felt a duty to monitor or police the actions of their colleagues or to report their misdeeds. Banking culture has all too often been characterised by an absence of any sense of duty to the customer and a similar absence of any sense of collective responsibility to uphold the reputation of the industry....

That regulation is well-intentioned is no guarantee that it is a force for good. Misconceived and poorly-targeted regulation has been a major contributory factor across the full range of banking standards failings. Regulators cannot always be expected to behave as disinterested guardians who will pursue the "right" approach. They are faced with complex challenges to which the appropriate solutions are ambiguous and contested. They have not in the past always risen to those challenges satisfactorily. They need to resist the temptation to retreat into a comfort zone of setting complex rules and measuring compliance. They also need to avoid placing too much reliance on complex models rather than examining actual risk exposures. Regulators were complicit in banks outsourcing responsibility for compliance to them by accepting narrow conformity to rules as evidence of prudent conduct. Such an approach is easily gamed by banks, and is no substitute for judgement by regulators....

The favourable treatment of banking by regulators and governments has not merely been the consequence of smooth lobbyists seducing naive politicians. The economic growth and tax revenues promised by a booming sector over the relatively brief political cycle dazzled governments around the world. This encouraged excess and undermined regulators. Public anger with bankers has now dimmed this effect, but its possible revival in calmer economic times, when bankers are off the front pages, should remain a deep concern...

The distorted incentives in banking are nowhere more apparent than in the asymmetry between the rewards for short-term success and costs of long-term failure for individuals. Many bankers were taking part in a one-way bet, where they either won a huge amount, or they won slightly less and taxpayers and others picked up the tab, even if some individuals paid a large reputational price. Many have continued to prosper while others, including the taxpayer, continue to foot the bill for their mistakes. There have been a few isolated instances of individual sanction, but these have rarely reached to the very top of banks. This sanctioning of only a few individuals contributes to the myth that recent scandals can be seen as the result of the actions of a few 'rotten apples', rather than much deeper failings in banks, by regulators and other parts of the financial services industry...

Banking has been a great British strength, but for that reason is also an important source of risk to Britain. A series of factors, considered below, combine to give the UK an inherent advantage as a place to do financial business. Properly harnessed, finance can greatly add to nationwide prosperity. However, recent history has demonstrated that, whether or not the benefits of a large banking sector have been overstated, the risks were certainly understated. Given the huge size of the banking sector in the UK relative to the overall size of the economy, it is important that policy-makers and regulators balance support for the sector with proper safeguards to limit the potential damage it can do to the UK economy and to taxpayers if things go wrong. The banking collapse of 2008 shows these risks are very real...

Policy-makers should be aware of the risks of relocation, but should not be held hostage by them. Around the world there is a move to stronger regulation and to learning the lessons of what happened in the run up to 2008. The UK must not be intimidated out of making the changes necessary to protect the public by threats of bank relocation. ..

The UK should do what is necessary to secure London's position as a pre-eminent and well-regulated financial centre in order to make sure that it represents an attractive base for whatever tomorrow's financial sector may look like. High standards in banking should not be a substitute for global success. On the contrary, they can be a stimulus to it...

Policy-makers in most areas of supervision and regulation need to work out what is best for the UK, not the lowest common denominator of what can most easily be agreed internationally. There is nothing inherently optimal about an international level playing field in regulation. There may be significant benefits to the UK as a financial centre from demonstrating that it can establish and adhere to standards significantly above the international minimum. A stable legal and regulatory environment, supporting a more secure financial system, is likely to attract new business just as ineffective or unnecessarily bureaucratic regulation is likely to deter it...

The UK's ability to make necessary reforms to financial regulation risks being constrained by the European regulatory process, which is developing rapidly as Eurozone countries move towards banking union. Some new financial regulation across the EU may be desirable as a support for the Single Market. However, there are at least two dangers for the UK. The first is that the prescriptive and box-ticking tendency of EU rules designed for 27 members will impede the move towards the more judgement-based approach being introduced in the UK in response to past regulatory failures. The second is that some EU regulations may limit the UK's regulatory scope for unilateral action. This could mean moving at the speed of the slowest ship in the convoy. This is a risk which the UK, as a medium-sized economy hosting one of the world's two most important financial centres, cannot afford.

The potential for regulatory reforms to drive some activities out of banks and into "shadow banking" should not be viewed as a reason not to act. The migration of some of the higher risk activity currently conducted by banks to non-bank companies is already happening on a large scale and, in many cases, this is welcome. It is making some big banks smaller and simpler, shifting some risks to structures better suited to handling them, and weakening the links between these risks and the core of the banking system. Shadow banks do not believe that they will be bailed out by the taxpayer and those that run them often have their shirts on the line. This move would, however, become problematic if, as happened in the United States in 2008, highly-leveraged shadow banks became over-exposed to core banking risks, for example related to maturity transformation, and themselves become too big and interconnected to fail. It is therefore essential that the Bank of England, FPC and PRA take seriously the task of monitoring shadow banking...

... for a very long time, the regulatory authorities in the UK have displayed an instinctive resistance to new entrants. This conservatism must end. The regulators' approach to authorising and approving new entrants, particularly those with distinct models, will require close monitoring by the Government and by Parliament, and the regulator should report to Parliament on progress in two years time...

... Peer-to-peer and crowdfunding platforms have the potential to improve the UK retail banking market as both a source of competition to mainstream banks as well as an alternative to them. Furthermore, it could bring important consumer benefits by increasing the range of asset classes to which consumers have access. This access should not be restricted to high net worth individuals but, subject to consumer protections, should be available to all. The emergence of such firms could increase competition and choice for lenders, borrowers, consumers and investors....

Alternative providers such as peer-to-peer lenders are soon to come under FCA regulation, as could crowdfunding platforms. The industry has asked for such regulation and believes that it will increase confidence and trust in their products and services. The FCA has little expertise in this area and the FSA's track record towards unorthodox business models was a cause for concern. Regulation of alternative providers must be appropriate and proportionate and must not create regulatory barriers to entry or growth. The industry recognises that regulation can be of benefit to it, arguing for consumer protection based on transparency. This is a lower threshold than many other parts of the industry and should be accompanied by a clear statement of the risks to consumers and their responsibilities. ...

What's wrong with the Approved Persons Regime

As the primary framework for regulators to engage with individual bankers, the Approved Persons Regime is a complex and confused mess. It fails to perform any of its varied roles to the necessary standard. It is the mechanism through which individuals can notionally be sanctioned for poor behaviour, but its coverage is woefully narrow and it does not ensure that individual responsibilities are adequately defined, restricting regulators' ability to take enforcement action. In principle, it is the means by which the regulator can control those who run banks, but in practice it makes no attempt to set clear expectations for those holding key roles. It operates mostly as an initial gateway to taking up a post, rather than serving as a system through which the regulators can ensure the continuing exercise of individual responsibility at the most senior levels within banks. The public are rightly appalled by the small number of cases in which highly-paid senior bankers have been disciplined for the costly mistakes they have allowed to occur on their watch.

Faced with the weaknesses of the Approved Persons Regime laid bare by the failures of individuals in recent years, the FSA responded to the need for reform with dilatoriness, seemingly paralysed by the operational deficiencies of the existing system and unwilling to contemplate moving away from the familiarity it represents. Changes first mooted in January 2010 and agreed in September that year have gone back to the drawing board and been made subject to a further consultation, preceded by a pilot review and then a full review.

The FSA and its successors have proposed changes to the Approved Persons Regime, but there is a risk that these may be pursued with the timid approach of recent years. We have considered the case for reform of the Approved Persons Regime, but have concluded that incremental change will no longer suffice. A new regulatory framework for individuals within banking is urgently needed, and it cannot be secured by adding new layers on the rickety foundations of the Approved Persons Regime....

Making a choice

Poor standards in banking and the public's response to them have generated an impetus within the banking industry to make proposals for professional banking standards. This impetus is welcome and must be harnessed. Some progress can be achieved through the emergence of a credible professional body in banking, and the next section identifies important milestones in such a process.

However, it is questionable whether the business of banking possesses sufficient characteristics of a profession to lend itself to direct control through a professional body. "Banking" involves a wide range of activities and lacks the large common core of learning which is a feature of most professions. It is a long way from being an industry where professional duties to customers, and to the integrity of the profession as a whole, trump an individual's own behavioural incentives. A professional body alone does not guarantee high standards, as illustrated by the varied scandals in a range of other sectors where such bodies exist.

There are also very substantial risks of duplication between the powers and role of a professional standards body and those of regulators, as well as risks that the creation of such a body could become a focus of public policy, diverting attention from the changes that are urgently needed within the existing regulatory framework.

Milestones for a professional body

If a unified professional body for banking in the UK is to emerge, the onus should lie on the industry itself to maintain the impetus for its development. Such a body needs first and foremost to be created through the will, and with the resources, of banks and those who work in the UK banking sector. The Commission's aim in this section is to identify milestones for its development and to assist in fostering its establishment and growth. However, the emergence of a professional body should be consistent with the wider regulatory and legislative reforms needed in banking. It must not be seen as a necessary precursor to those reforms, still less as a substitute for them.

Banks maintain that there would be benefits if they were to adopt, implement and commit to enforce a single code of conduct prepared by a unified professional body, which reflected a higher set of standards and expectations for individual behaviour than those required by the regulator. Providing statutory powers to a professional body would mean either stripping away many powers from the regulators, including the new powers that we propose in this and subsequent chapters, or risking double jeopardy for individuals. No proponents of a professional body have come forward with a plan which the Commission believes is credible for how to address this problem.

While we support the creation of a professional standards body to promote higher professional standards in banking, the case for it to share or take over formal responsibility for enforcement in banking will only gradually be able to prove itself and so we do not recommend the establishment of such a body as an alternative to other regulatory measures. However, preliminary work to establish a professional body should begin immediately as a demonstration that commitment to high standards is expected throughout banking and that individuals are expected to abide by higher standards than those that can be enforced through regulation alone. On the basis of our assessment of the nature of the banking industry, we believe that the creation of an effective professional body is a long way off and may take at least a generation. It is therefore important that the trajectory towards professionalisation is clearly signalled immediately and that initial practical proposals for such a body are tabled at an early stage. Work can begin immediately on bodies for the most readily identifiable parts of banks which would benefit from professional standards. These include retail banking, the most senior levels and specialist areas such as insolvency and debt recovery.

An important milestone on the road to the successful development of a professional standards body would be that it could claim comprehensive coverage of all banks with operations in the UK. If banks were to decline to assist in a body's development, or to seek to resile from participation in due course, the credibility and effectiveness of the body would be significantly damaged.

A unified professional body for banking should have no need of public subsidy, either directly or indirectly. We would expect such a body to be funded by participating banks and individual qualified members. However, it would also need to establish independence from the outset, through its forms of governance, its disciplinary procedures and through the personnel at senior levels. The body must never allow itself to become a cosy sinecure for retired bank chairmen and City grandees. Just as importantly, it must eschew from the outset and by dint of its constitution any role in advocacy for the interests of banks individually or collectively...

The Senior Persons Regime

In the remaining sections of this chapter we set out the three main pillars of a new system to replace the Approved Persons Regime:

- A Senior Persons Regime to replace the Significant Influence Function element of the Approved Persons Regime. This should provide far greater precision about individual responsibilities than the system that it replaces, and would serve as the foundation for some of the changes to enforcement powers and approach that we recommend in Chapter 10;

- A Licensing Regime to replace the Approved Persons Regime as the basis for upholding individuals' standards of behaviour, centred on the application of a revised set of Banking Standards Rules to a broader group than those currently covered by the Statement of Principles for Approved Persons; and
- Reform of the register to support the first two pillars and ensure that relevant information on individuals can be captured and used effectively.

The Commission recommends that the Approved Persons Regime be replaced by a Senior Persons Regime. The new Senior Persons Regime must ensure that the key responsibilities within banks are assigned to specific individuals who are aware of those responsibilities and have formally accepted them. The purposes of this change are: first, to encourage greater clarity of responsibilities and improved corporate governance within banks; second, to establish beyond doubt individual responsibility in order to provide a sound basis for the regulators to impose remedial requirements or take enforcement action where serious problems occur. This would not preclude decision-making by board or committee, which will remain appropriate in many circumstances. Nor should it prevent the delegation of tasks in relation to responsibilities. However, it would reflect the reality that responsibility that is too thinly diffused can be too readily disowned: a buck that does not stop with an individual stops nowhere.

The Senior Persons Regime should apply to all banks and bank holding companies operating in the UK. The Commission would expect that the Senior Persons Regime would cover a narrower range of individuals than those currently in Significant Influence Functions. Many of the people in these functions are not really senior decision-takers. Taking them out of scope, though still subject to the Licensing Regime that we propose below, would allow the Senior Persons Regime to focus much more clearly on the people who really run banks and who should stand or fall by their role in decision-making. Beyond board and executive committee members, who should always be within scope, primary responsibility for identifying which individuals fall within the regime and how their responsibilities are defined should rest in the first instance with the banks themselves. We would expect such responsibilities to cover both prudential and conduct issues, such as product design. It should not be for the regulator to prescribe how banks structure their management, because it is important that banks retain the flexibility to do this in the most appropriate way for their business.

The Commission recommends that regulators set out in guidelines how responsibilities are to be identified and assigned, and should have the power to take action against firms when it is satisfied that they are not following these guidelines. We would expect these to include the points below:

- All key activities that the business undertakes or key risks to which it is 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 may 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 cannot report directly to anyone within a UK-based organisation who is not themselves a Senior Person; and
-A bank's board should have a duty to regularly certify to the regulator that their firm is fulfilling its obligations under the Senior Persons Regime.

Regulators will need to show judgement and realism in exercising their enhanced powers. The Commission recommends that the regulators also be given a power to designate time-limited or remedial responsibilities that must be assigned to an individual within or thereby brought within the Senior

Persons Regime.

It would be a mistake to prescribe a one-size-fits-all approach to the assessment of fitness and properness to assume a position as a Senior Person. What matters more is that the checks are geared to the responsibilities proposed for the individual and reflect supervisory judgement by senior regulators with involvement in the supervision of the bank concerned, rather than a box-ticking exercise by an isolated unit. The stated intention of regulators to focus more rigorous pre-approval checks on a smaller number of key individuals is to be welcomed.

The Commission considers that it would be unduly onerous for both the regulators and the regulated to make Senior Person status subject to periodic review. However, the Commission recommends that the regulators be given clear discretionary powers to review the assignment of responsibilities to a particular individual and require the redistribution of certain responsibilities or the addition of certain conditions. We would expect these powers to be exercised where, for example, a bank undergoes rapid expansion or where the regulators have reason to question a bank's approach to the allocation of responsibilities. We also recommend that the regulators be able to make approval of an individual Senior Person subject to conditions, for example where it is felt that they need to acquire a certain skill to carry out the job well. It is essential that the regime evolve and adapt over time. It would be a disaster if it were to relapse back into a one-off exercise that applied, in practice, only on entry, as with the Approved Persons Regime.

Arrangements for the allocation of individual responsibilities within banks will need to take account of changes in personnel. The Commission recommends that it be a requirement of those in the Senior Persons Regime that, before relinquishing any responsibilities that are to be passed to a successor, they prepare a handover certificate outlining how they have exercised their responsibilities and identifying the issues relating to their responsibilities of which the next person holding them should be aware. Such handover certificates should be held by banks as a matter of record, and should be 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. Such a certificate could also serve as an important source of information in recouping remuneration in accordance with our proposals in Chapter 8.

The Licensing Regime

Regulators' ability to take enforcement action only against individuals who are covered by the Approved Persons Regime results in inadequate coverage, notwithstanding the fact that, in practice, such enforcement action has seldom been taken. Additionally, requiring that only this relatively small sub-set of bankers needs to uphold the Statements of Principle for Approved Persons undermines a wider sense of responsibility and aspiration to high standards throughout the banking sector. We have already considered and rejected proposals to rely solely on a professional standards body and a code of conduct to address these problems. Instead, the Commission recommends the establishment of a Licensing Regime alongside the Senior Persons Regime. Under this a broader set of bank staff would be contractually obliged to adhere to a set of Banking Standards Rules, which the regulators could enforce against and which would replace the existing statements of principle.

The Commission recommends that the Licensing Regime cover 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 would not need to cover staff working in auxiliary or purely administrative roles, or those in junior positions whose autonomy and responsibility is very limited. Such a scope is likely to include all staff currently covered by the Approved Persons Regime, including those in customer dealing functions.

Because the Licensing Regime will be broader in its application than the Approved Persons Regime it is important that it operate with a minimum of bureaucratic process. Entry should not require pre-approval by the regulators, but should require employers to verify the fitness and propriety of staff, including checking the register for any record of past disciplinary action. The existing Statements of Principle for Approved Persons and the accompanying code of conduct are not intrinsically wrong, but they do not constitute a sufficiently robust foundation for improving banking standards. The Commission recommends that regulators develop, after consultation with banks, staff, unions and those bodies already working on codes of conduct, a new set of Banking Standards Rules. These should draw on the existing principles and apply to a wide group of individuals, forming the foundation of their understanding for how they are expected to behave: the rules should be written in a way which is readily meaningful for those who must adhere to them, unlike the current statements and code which are complex and heavy with legalistic cross-references to other regulations. The rules should be generally applicable to all individuals within the Licensing Regime, rather than sub-divided depending on category of employee. The rules should explicitly encapsulate expectations about behaviour which are currently absent from the statements of principle for individuals, such as treating customers fairly and managing conflicts of interest and a requirement to draw to the attention of senior management and regulators conduct which falls below the standards set out.

Banks should not be able to offload their duties and responsibilities for monitoring and enforcing individual behaviour on to the regulator or on to professional bodies. The tools at their disposal have the potential to be much more usable, effective and proportionate for the majority of cases than external enforcement, which should remain the backstop for more serious breaches.

The new licensing duty should not be unduly onerous. Some banks may already, in practice, have in place much of the control framework required to implement the Licensing Regime. Banks should already know the employees whose actions or behaviour could seriously harm the bank, its reputation or its customers. Banks should also already monitor their work closely and fully explain to individuals their contractual responsibilities. Many banks have already acknowledged that they need to do more in this area, but the incentives for them to translate this into action are not apparent.

The new Licensing Regime should therefore not only ensure that all relevant staff are covered by a common set of rules which are enforceable by the regulators, but should also formalise banks' responsibilities for ensuring that staff understand and demonstrate the high standards set out in the regime. This should make clear banks' primary responsibility for taking disciplinary action under an employee's contract of employment when standards are breached. Banks' implementation of the Licensing Regime should be subject to monitoring by regulators and enforcement action where firms are found to be failing in their duties.

It should be the job of the bank as employer to inform and instruct each licensed person of his or her responsibilities and to keep accurate records. Individuals within the Licensing Regime who are not Senior Persons can nevertheless have important responsibilities which could have a significant impact on the bank or its customers. The Commission recommends that the regulators have the discretionary power to require those leaving such posts to prepare handover certificates in line with our earlier recommendation in relation to Senior Persons. Banks may want to provide training and support to employees to help them understand how the banking standards rules translate to an individual's specific role, and reflect the rules in their own appraisal processes. Professional standards bodies may be able to play a valuable role in this area. However, the creation and implementation of such a process should not be held by the regulator to be a substitute for compliance with the substance of the standards rules. Most bankers may behave honourably "when no-one is watching", but some will do so only if there is a genuine prospect that someone might in fact come looking. Banks need to maintain and where necessary implement systems that include checks and random audits, rather than simply addressing standards issues with process-driven training or when those issues hit the front pages and threaten the brand. In support of these responsibilities of the firm, we would expect a Senior Person to be directly responsible for the performance by a bank of its licensing responsibilities.

This proposal builds on the ideas put forward by senior bankers for banks to improve individual standards through self-regulation. However, the Licensing Regime benefits from robust regulatory underpinning. This is essential, in view of the shortcomings of self-regulatory arrangements in financial services in the past.

The Commission is well aware that neither the Senior Persons Regime nor the Licensing Regime can resolve the multi-faceted problems of banking standards. But they can make a contribution. They give banks an opportunity to demonstrate that they are putting their houses in order, in a way which could reduce the costly bureaucracy inherent in the ever more complex reforms of the Approved Persons Regime currently being considered. They also give regulators more effective tools to hold individuals to account and, through them, unambiguous responsibility for ensuring that banks adhere to higher standards.

Reforming the register

It will be important for the register underpinning the current Approved Persons Regime to be reformed to take account of the Commission'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 is likely to be more proportionate only to include their details where there has 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 is merited. Regulators should be able to retain such information for their own purposes even where they decide not to proceed with enforcement action. The regulators should explore whether information about disciplinary dismissals could also be communicated to prospective employers, although the Commission recognises the potential legal difficulties with such an approach.

Sanctions imposing restrictions on practising can only be effective if they cannot be circumvented by moving within the industry. Strengthening the register will address this domestically, but much more should also be done to move to mutual recognition of sanctions between jurisdictions. Of particular benefit would be an obligation on firms to take account of any misdemeanours recorded on the register in other jurisdictions before hiring staff. The need for such an obligation between the US and UK is particularly important. The development of such an obligation, and in particular comprehensive coverage, may take time. It might ultimately require legislative change both here and in the US to be effective. The Commission recommends that the Government and the UK regulators initiate early discussions with US counterparts on this issue. Subsequent discussions with the EU and other financial centres may also be appropriate...

Internal controls and disciplines

Each bank board should have a separate risk committee chaired by a non-executive director who possesses the banking industry knowledge and strength of character to challenge the executive effectively. The risk committee should be supported by a strong risk function, led by a chief risk officer, with authority over the separate business units. Boards must protect the independence of the Chief Risk Officer, and personal responsibility for this should lie with the chairman of the risk committee. The Chief Risk Officer should not be able to be dismissed or sanctioned without the agreement of the non-executive directors, and his or her remuneration should reflect this requirement for independence. The Chief Risk Officer should be covered by the Senior Persons Regime, and the responsibilities assigned to the holder of that post should make clear that the holder must maintain a voice that is independent of the executive.

It is important that banks have clear lines of accountability for the assurance of overall regulatory compliance. A blurring of responsibility between the front line and compliance staff risks absolving the front line from responsibility for risk. Compliance involvement in product development can make it more difficult for compliance staff subsequently to perform their independent control duties. Their involvement needs careful handling. Responsibility for acting in accordance with the letter and spirit of regulation should lie with every individual in a bank. This responsibility should not be outsourced to a compliance function, any more than to the regulator itself, particularly in the light of the fact that, owing to the complexity of banks, the compliance function would face a very difficult task were this responsibility to lie solely with it.

The Commission notes with approval measures taken by banks to involve control functions in the performance assessment of senior and front-line staff. There is a strong case for extending this further. To have a strong impact on behaviour, clarity in how such mechanisms operate is desirable. The involvement of the front-line in assessing second-line performance threatens to further undermine the independence of the second line. This effect can be exacerbated by ingrained status differences between staff in different functions.

We do not wish to be prescriptive about the role of the Head of Compliance. We see parallels with the role of the Chief Risk Officer, insofar as protecting the independence of the Head of Compliance role is paramount. This should be a particular responsibility of a named individual non-executive director. The Commission recommends, as with the Chief Risk Officer, that dismissal or sanctions against the Head of Compliance should only follow agreement by the non-executive directors. Such an action would, under existing arrangements, also need to be disclosed to the regulator.

Internal audit's independence is as important as that of the Chief Risk Officer and the Head of Group Compliance, and its preservation should similarly be the responsibility of a named individual non-executive director, usually the chairman of the audit committee. Dismissal or sanctions against the head of internal audit should also require the agreement of the non-executive directors.

The "three lines of defence" have not prevented banks' control frameworks failing in the past in part because the lines were blurred and the status of the front-line, remunerated for revenue generation, was dominant over the compliance, risk and audit apparatus. Mere organisational change is very unlikely, on its own, to ensure success in future. Our recommendations provide for these lines to be separate, with distinct authority given to internal control and give particular non-executive directors individual personal responsibility for protecting the independence of those responsible for key internal controls. This needs to be buttressed with rigorous scrutiny by the new regulators of the adequacy of firms' control frameworks.

Standards and culture

Profound cultural change in institutions as large and complex as the main UK banks is unlikely to be achieved quickly. Bank leaders will need to commit themselves to working hard at the unglamorous task of implementing such change for many years to come.

Poor standards in banking are not the consequence of absent or deficient company value statements. Nor are they the result of the inadequate deployment of the latest management jargon to promulgate concepts of shared values. They are, at least in part, a reflection of the flagrant disregard for the numerous sensible codes that already existed. Corporate statements of values can play a useful role in communicating reformist intent and supplementing our more fundamental measures to address problems of standards and culture. But they should not be confused with solutions to those problems.

The appropriate tone and standard of behaviour at the top of a bank is a necessary condition for sustained improvements in standards and culture. However, it is far from sufficient. Improving standards and culture of major institutions, and sustaining the improvements, is a task for the long term. For lasting change, the tone in the middle and at the bottom are also important. Unless measures are taken to ensure that the intentions of those at the top are reflected in behaviour at all employee levels, fine words from the post-crisis new guard will do little to alter the fundamental nature of the organisations they run. There are some signs that the leaderships of the banks are moving in the right direction. The danger is that admirable intentions, a more considered approach, and some early improvements, driven by those now in charge, are mistaken for lasting change throughout the organisation.

We believe that the influence of a professional body for banking could assist the development of the culture within the industry by introducing non-financial incentives, which nonetheless have financial implications, such as peer pressure and the potential to shame and discipline miscreants. Such a body could, by its very existence, be a major force for cultural change and we have already recommended that its establishment should be pursued as a medium to long term goal alongside other measures such as new regulatory provisions.

There is little point in senior executives talking about the importance of the customer and then putting in place incentive and performance management schemes which focus on sales which are not in the interests of the customer. As long as the incentives to break codes of conduct exceed those to comply, codes are likely to be broken. Where that gap is widest, such as on trading floors, codes of conduct have gained least traction. This betrays a wider problem with stand-alone programmes to raise standards and improve culture. Attempts to fix them independently of the causes are well-intentioned and superficially attractive, but are likely to fail.

The culture on the trading floor is overwhelmingly male. The Government has taken a view on having more women in the boardroom through the review carried out by Lord Davies of Abersoch and his recommendations that FTSE 100 companies increase the number of women directors who serve on their boards. If that is beneficial in the boardroom so it should be on the trading floor. The people who work in an industry have an impact on the culture of that industry. More women on the trading floor would be beneficial for banks. The main UK-based banks should publish the gender breakdown of their trading operations and, where there is a significant imbalance, what they are going to do to address the issue within six months of the publication of this Report and thereafter in their annual reports.

In order for banks to demonstrate to the public that they have changed their standards and culture, they will need to provide clear evidence of such change. Banks are well aware of their past failings. They should acknowledge them. Further opportunity to demonstrate change is offered by ongoing concerns, such as approaches taken to customer redress or involvement in activities inconsistent with a customer service ethos. The clearest demonstration of change will come with the avoidance of further standards failings of the sort that led to the creation of the Commission.

Driving out fear

The Commission was shocked by the evidence it heard that so many people turned a blind eye to misbehaviour and failed to report it. Institutions must ensure that their staff have a clear understanding of their duty to report an instance of wrongdoing, or 'whistleblow', within the firm. This should include clear information for staff on what to do. Employee contracts and codes of conduct should include clear references to the duty to whistleblow and the circumstances in which they would be expected to do so.

In addition to procedures for formal whistleblowing, 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. It is in the long-term interest of banks to have mechanisms in place for ensuring that any accumulation of concerns in a particular area is acted on. Accountability for ensuring such safeguards are in place should rest with the non-executive director responsible for whistleblowing.

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. That Board member must be satisfied that there are robust and effective whistleblowing procedures in place and that complaints are dealt with and escalated appropriately. It should be his or her personal responsibility to see that they are. This reporting framework should provide greater confidence that wider problems, as well as individual complaints, will be appropriately identified and handled.

The Commission recommends that the Board member responsible for the institution's whistleblowing procedures be held personally accountable for protecting whistleblowers against detrimental treatment. It will be for each firm to decide how to operate this protection in practice, but, by way of example, the Board member might be required to approve significant employment decisions relating to the whistleblower (such as changes to remuneration, change of role, career progression, disciplinary action), and to satisfy him or herself that the decisions made do not constitute detrimental treatment as a result of whistleblowing. Should a whistleblower later allege detrimental treatment to the regulator, it will be for that Board member to satisfy the regulator that the firm acted appropriately.

Whistleblowing reports should be subjected to an internal 'filter' by the bank to identify those which should be treated as grievances. Banks should be given an opportunity to conduct and resolve their own investigations of substantive whistleblowing allegations. We note claims that 'whistleblowing' being treated as individual grievances could discourage legitimate concerns from being raised. (Paragraph 792)

The regulator 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.

All Senior Persons should have an explicit duty to be open with the regulators, not least in cases where the Senior Person becomes aware of possible wrongdoing, regardless of whether the Senior Person in question has a direct responsibility for interacting with the regulators.

The FCA's evidence appeared to show little appreciation of the personal dilemma that whistleblowers may face. The FCA should regard it as its responsibility to support whistleblowers. It should also provide feedback to the whistleblower about how the regulator has investigated their concerns and the ultimate conclusion it reached as to whether or not to take enforcement action against the firm and the reasons for its decision. The Commission recommends that the regulator require 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. The regulator can then consider whether to take enforcement action against individuals or firms who are found to have acted in a manner inconsistent with regulatory requirements set out in the regulator's handbook. In such investigations the onus should be on the individuals concerned, and the non-executive director responsible within a firm for protecting whistleblowers from detriment, to show that they have acted appropriately.

We note the regulator's disquiet about the prospect of financially incentivising whistleblowing. The Commission calls on the regulator to undertake research into the impact of financial incentives in the US in encouraging whistleblowing, exposing wrongdoing and promoting integrity and transparency in financial markets.

We have said earlier in this Report 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.

A poorly designed whistleblowing regime could be disruptive for a firm but well designed schemes can be a valuable addition to its internal controls. 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.

Remuneration

Rewards out of kilter

Remuneration lies at the heart of some of banks' biggest problems. Risk and reward are misaligned, incentivising poor behaviour. The core function of banks should be to manage and price the risk inherent in the taking of loans and deposits and in holding other financial products over different time periods. One effect of limited liability is to enable individuals to extract high rewards predicated on disproportionate risks, sheltered from exposure to commensurate potential losses. This misalignment has been further reinforced by the implicit taxpayer guarantee and by the practice of making pay awards over a relatively short period. This has included remuneration for the creation and marketing of products, to retail and wholesale customers, for which the full costs and benefits may not be clear for many years. The risk inherent in complex derivatives is particularly hard to assess.

Aggregate remuneration continues to consume a high share of returns relative to shareholder dividends and capital. From this share, a relatively small proportion of senior management and supposedly irreplaceable key staff have received very large rewards. Banks should be free to compete in the global market: the use of remuneration to retain the most productive staff is a legitimate management tool. However, the financial crisis and its aftermath have exposed the extent to which many of the highest rewards were unjustified. Senior bankers have also benefited from a remuneration consultancy industry whose advice may itself have been distorted by conflicts of interest and by board Remuneration Committees trapped into ever higher awards by allegiance to colleagues and the ratchet effect of industry competitors. A culture of entitlement to high pay developed which has yet fully to be dispelled.

Over time, increased capital ratios, lower levels of leverage and structural changes to reduce the scale of the implicit taxpayer guarantee through ring-fencing will help to redress the misaligned incentives. However, these measures will not address all the problems that remain. Further public policy intervention is required.

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.

Fixed and variable remuneration

The scale and forms of variable remuneration as they have been paid to staff at senior levels in banks, and investment banking in particular, have encouraged the pursuit of high risks for short-term gain, at times seemingly heedless of the long-term effects. The high levels of variable remuneration that persisted in the sector even after 2008 are difficult to justify.

There are distinct advantages to a significant proportion of banking remuneration being in variable rather than fixed form. It is easier to adjust variable remuneration to reflect the health of an individual bank. The use of variable remuneration also allows for deferral and the recouping of rewards in ways which better align remuneration with the longer term interests of a bank. There are signs already that the fall in bonuses in recent years has been offset by an increase in fixed remuneration. We note that Andrew Bailey considered that the EU bonus cap would "push up fixed remuneration" rather than act to reduce overall pay. We are not convinced that a crude bonus cap is the right instrument for controlling pay, but we have concluded that variable remuneration needs reform.

Yardsticks for variable remuneration

Many of the so-called profits reported by banks in the boom years turned to dust when markets went into reverse. However, for some individual bankers, they had served their purpose, having been used in calculations leading to huge bonuses which could not be recouped. The means by which profits are calculated for remuneration purposes needs to change, even if there is no change in the accounting standards which underpin reported profits and losses. Unless they change, incentive structures will continue to encourage imprudent banking. In Chapter 9 we consider the case for the introduction of regulatory accounts. Alongside any change in this area, the Commission recommends that regulators set out, within the new Remuneration Code, criteria for the determination of profits for remuneration purposes, at company level and from business units. We would expect that unrealised profits from thinly traded or illiquid markets would usually not be appropriate for this purpose.

Banks and regulators should avoid relying unquestioningly on narrow measures of bank profitability in setting remuneration. One measure which has commonly been used—return on equity—creates perverse incentives, including the incentive to use debt rather than equity to finance bank activity, thus increasing leverage. Using return on assets as an alternative measure would remove the incentive towards leverage, but carries its own problems, including an incentive to hold riskier assets. While a measure based on risk-weighted return could help address this, we have noted the severe limitations of risk-weighting in the context of the Basel II and Basel III framework.

The Commission recommends that bank remuneration committees disclose, in the annual report, the range of measures used to determine remuneration, including an explanation of how measures of risk have been taken into account and how these have affected remuneration. The regulators should assess whether banks are striking an appropriate balance between risk and reward. They should be particularly sceptical about reliance on return on equity in calculating remuneration. The regulators should also assess whether the financial measures that are used cover adequately the performance of the entire bank as well as specific business areas. The former serves to create a collective interest in the long-term success of the institution. Where it is not satisfied, the regulator may need to intervene. It is for banks to set remuneration levels, but it is for regulators to ensure that the costs and benefits of risks in the long term are properly aligned with remuneration. This is what judgement-based regulation should mean.

Misaligned remuneration incentives have also contributed to conduct failure, including scandals such as PPI. The Commission welcomes announcements by some banks that retail staff will no longer be rewarded based on their sales, but notes the widespread warnings that sales-based rewards may persist informally even where their explicit inclusion in incentive schemes is removed. The Commission recommends that the new Remuneration Code 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.

Reforming variable remuneration

Variable remuneration does not form a large proportion of total pay for the vast majority of bank staff. However, the use of very high bonuses, both in absolute terms and relative to salaries, is more prevalent in banking than in other sectors. As we have already noted, there are advantages to variable rather than fixed remuneration, but it is essential that the use of variable remuneration is far better aligned with the longer term interests of the bank. The Commission's proposals which follow do not relate simply to investment bankers or directors, but should apply to all those whose actions or behaviour could seriously harm the bank, its reputation or its customers. They should apply not only to all Senior Persons but also to all licensed staff receiving variable remuneration...

The remuneration of senior bankers has tended to suffer from the fundamental flaw that annual rewards were not sufficiently aligned with the long-term interests of the firm. Bankers often had something akin to "skin in the game" through payment of part of bonuses and long term incentive plans in equity. But this provided unlimited upside but with the limited liability that comes with equity putting a floor under the downside. The Commission recommends that there should be a presumption that all executive staff to whom the new Remuneration Code applies receive variable remuneration and that a significant proportion of their variable remuneration be in deferred form and deferred for longer than has been customary to date. In some cases, there is a danger that individuals will be penalised for the poor performance of their colleagues or successors. However, such concerns are outweighed by the advantages of ensuring that these staff have a bigger personal interest in, and responsibility for, the long-term future of the bank. This will change behaviour for the better. It is particularly important for some of the team-based functions where members have often felt a greater loyalty to the small team than to the wider bank interest. By linking rewards much more closely to long term risks, deferral can recreate some of the features of remuneration structures characteristic of unlimited liability partnerships.

For the most senior and highest rewarded it is even more crucial that their remuneration reflects the higher degree of individual responsibility expected of them. Flexibility on the part of firms, and judgement on the part of regulators, is essential to take account of wide variations of risk and time horizons of its maturity in different areas of banking. Poorly designed schemes may increase the risk of gaming or circumvention of regulations and will have adverse or perverse affects on behaviour.

Too high a proportion of variable remuneration in the banking sector is often paid in the form of equity or instruments related to future prospects for equity in the bank concerned. The path of share prices after remuneration has been awarded is unlikely to reflect accurately the quality of decisions made and actions taken in the period to which the award relates. Too much reliance on equity value creates perverse incentives for leverage and for short-termism. There are merits in the greater use of instruments such as bail-in bonds in deferred compensation. If senior staff are liable to lose their deferred pay if the bank goes bust, it will concentrate minds. In the event of capital inadequacy, such instruments would convert into capital available to absorb losses. However, there is no package of instruments which necessarily best matches risks and rewards in each case. Flexibility in the choice of instruments is vital. Banks should make this choice, dependent on particular circumstances. It is equally important that the supervisor assesses whether these choices are consistent with the appropriate balance of risks and rewards.

The ability to defer a proportion of an individual's bonus is an important feature of remuneration schemes for those in senior decision-making and risk-taking roles in banks. This is because bonuses are typically awarded annually, while profits or losses from banking transactions may not be realised for many years. Similarly, misconduct may be identified only some time after the misbehaviour has occurred. 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. Deferral should be over a longer period than currently is the case. However, no single longer period is appropriate and flexibility in approach is required to align risk and rewards. This is the job of the bank, but the supervisor should monitor decisions closely, particularly where the individuals concerned pose the greatest potential risks. The Commission recommends that the new Remuneration Code include a new power for the regulators 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.

The deferral of variable remuneration for longer periods is so important because it allows that remuneration to be recouped in appropriate circumstances. Clawback or similar recovery is also an appropriate course of action in cases where fines are levied on the firm, such as for misconduct in relation to LIBOR. However, what matters more is the development of legal and contractual arrangements 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.

In the most egregious cases of misconduct, recovery of vested remuneration may be justified. The Commission recommends that the regulator examines whether there is merit in further powers, in the cases of individuals who have been the subject of successful enforcement action, to recover remuneration received or awarded in the period to which the enforcement action applied.

One of the fundamental weaknesses of bank remuneration in recent years has been that it lacked down-side incentives in the worst case scenarios that were remotely comparable to the upside incentives when things seemed to be going well. This disparity was laid bare by taxpayers bailing out failed banks while those responsible for failure continued to enjoy the fruits of their excess. We believe that the alignment of the financial interests of the most crucial bank staff with those of the bank is an important factor in addressing this imbalance. The Commission recommends accordingly that legislation be introduced to provide that, in the event that a bank is 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 Senior Persons and other licensed staff.

Our recommendations in this section are aimed at incentivising bank management and staff to prioritise appropriate conduct, and the safety and soundness of their organisation, by enabling some or all of the deferred remuneration to be recouped in the event of conduct or prudential failures emerging. Such deferral structures as the industry had prior to the financial crisis were intended as staff retention schemes, rather than to incentivise appropriate behaviour. Consequently, these awards are generally forfeited if an employee resigns from the firm during the vesting period. As a result, it is common practice for banks hiring staff from competitors to compensate recruits for the value they have forfeited, by awarding them equivalent rights in their own deferred compensation scheme. This is tantamount to wiping the slate clean and, if it continued, would blunt the intended effect of our recommendations. International agreement on this issue, while desirable, is unlikely. The Commission recommends that the regulators come forward with proposals for domestic reform in this area as a matter of urgency. Among possible proposals, they should consider whether banks could be required to leave in place any deferred compensation due to an individual when they leave the firm. The regulators should also examine the merits of a new discretionary regulatory power, in cases where a former employee would have suffered deductions from deferred remuneration, but does not do so as a result of having moved to another bank, to recover from the new employer the amount that would have been deducted. This would be on the understanding that the cost is likely to be passed on to the employee. The use of this power might be initiated by the former employer, or by the regulator, in specific instances such as company fines for misconduct.

The adoption of the proposals set out in this section would amount to a substantial realignment of the risks and rewards facing senior bankers. Even with legislative backing and Parliamentary support, there are considerable obstacles to their rapid and successful implementation. This area is subject to considerable international regulatory interest and there is a danger that further interventions could change the wider framework within which our recommendations would operate. The regulators should ensure that new employment contracts are consistent with effective deferral schemes and should be aware of the potential for gaming over-prescriptive rules, or encouraging the arbitrage of entitlements. In fulfilling these roles, the regulators should exercise judgement in determining whether banks are operating within the spirit of the Commission's recommendations as implemented.

Board remuneration

The Commission regards it as inappropriate for non-executives to receive some of their compensation in the form of shares or other instruments the aggregate amount of which could be influenced by leverage. A bank board should act as a bulwark against excessive risk-taking driven by individual rewards. The challenge and scrutiny responsibilities of non-executive directors are not consistent with the pursuit of additional awards based on financial performance. The Commission recommends that the new Remuneration Code prohibit variable, performance-related remuneration of non-executive directors of banks.

The international dimension

Remuneration requirements should, ideally, be mandated internationally in order to reduce arbitrage. The Commission expects the UK authorities to strive to secure international agreement on changes which are focused on the deferral, conditionality and form of variable remuneration, and the measures for its determination, rather than simply the quantitative relationship to fixed remuneration, because it is changes of this kind that will most improve the behaviour of bankers in the longer term. In particular, we expect the Government and the Bank of England to ensure that the technical standards under [the EU capital adequacy rules] contain sufficient flexibility for national regulators to impose requirements in relation to instruments in which deferred bonuses can be paid which are compatible with our recommendations.

It must be recognised, however, that international agreement on some of the changes we envisage may be neither fast not complete. This may lead some to advance the argument that the UK will be placed at a competitive disadvantage. The extent to which this is true has been overstated. The UK has great strengths as a financial centre, but, partly because of those strengths, it also faces substantial risks. The PRA must adopt a common sense and flexible approach to handling these issues. However, its overriding objective of financial stability should not be compromised and, in fulfilling this objective, the risk of an exodus should be disregarded.

Getting it done

The current terms of the Remuneration Code do not provide a clear basis for full implementation of our proposals. The Commission recommends that a new Remuneration Code be introduced on the basis of a new statutory provision, which should provide expressly for the regulators to prescribe such measures in the new Code as they consider necessary to secure their regulatory objectives.

Our recommendations place undue additional burdens on neither banks nor regulators. The proposals require banks to identify which staff are associated with high prudential or conduct risks and assess how the structures and timings of incentive schemes may affect the behaviour of employees. This should be tantamount to routine risk management in a well-run bank and banks should already be doing it as part of their internal controls. The regulator will need to check that the bank has identified the key risk-takers and decision-makers and confirm that deferred rewards will flow only when the full, long-term consequences of their decisions have become evident. The proposals require the careful examination of the remuneration of the highest risk Senior Persons Regime staff and spot checks on other licensed employees. Incentives are fundamental to the behaviour of individual bankers. Regulators should already be undertaking these checks.

There is a risk that increased regulatory oversight could lead to banks outsourcing their remuneration policies to the PRA, in the same way they outsourced risk management before the financial crisis. However, we anticipate that other changes will, over time, have the effect of imposing more effective market discipline on remuneration. The PRA should monitor remuneration carefully and report on it as part of the regular reporting of its activities.

The Commission recommends that banks' statutory remuneration reports 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 disclosure should include all elements of compensation and the methodology underlying the decisions on remuneration. The individual remuneration packages for executive directors and all those above a threshold determined by the regulator should normally be disclosed, unless the supervisor has been satisfied that there is a good reason for not doing so. The Commission further recommends that the remuneration report should be required to include a summary of the risk factors that were taken into account in reaching decisions and how these have changed since the last report.

We do not recommend the setting of levels of remuneration by Government or regulatory authorities. However, banks should understand that many consider the levels of reward in recent years to have grown to grotesque levels at the most senior ranks and that such reward often bears little relation to any special talent shown. This also needs to be seen in the context of the fact that many people have seen little or no increase in pay over the same period. We would encourage shareholders to take a more active interest in levels of senior remuneration. Individual rewards should be primarily a matter for banks and their owners. Nonetheless, we recognise that the measures we propose will radically alter the structure of bank remuneration. They will also provide far greater information to shareholders in carrying out their role.....

Sanctions and enforcement

Enforcement against banks

Effective enforcement action against firms represents an important pillar of the overall approach to enforcement. In many cases, it serves as the gateway to enforcement action against responsible individuals, which is also necessary. It can draw wider attention to a failure, providing incentives for firms to strive to maintain high standards, and establishes penalties when banks depart from those standards. The record of the regulators in enforcement against firms is patchy at best. It is notable that both significant prudential failures, for example at RBS, and some widespread conduct failures in the selling of PPI did not lead to successful enforcement against banks. In the investigations those at the top often absolved themselves by attesting their ignorance about the organisation of which they were in charge. It would run contrary to the public interest if the idea were to gain currency that banks can be too big or complex to sanction.

It is to be hoped that the LIBOR investigations have set a pattern for the future. In relation to prudential failings, formal action will assist in determining what went wrong and help to provide the basis for pursuing responsible individuals. In relation to conduct failings, a visible and costly redress process may not be enough: enforcement has the benefit of more clearly setting out where failures occurred and that rules were broken, so that culpability is not obfuscated and so that lessons can be learned.

It is right that an element of the fine should fall on shareholders, to provide a continuing incentive for them to monitor standards of conduct and supervision within the banks they own. However, our recommendations on recovery of deferred payments in Chapter 8 are designed to ensure that, in future, a significant proportion of fines on firms may be met from deductions from the remuneration of staff of the bank at the time of the misconduct, thereby making the prospect of fines on firms a more direct incentive on individuals to prevent it. There should be a presumption that fines on banks should be recovered from the pool of deferred compensation as well as current year bonuses. The recovery should materially affect to different degrees individuals directly involved and those responsible for managing or supervising them, staff in the same business unit or division, and staff across the organisation as a whole. The impact and distribution of fines on deferred compensation should be approved by the supervisors as part of a settlement agreement.

Firms cannot be permitted to regard enforcement fines as a "business cost". The FSA recognised that in the past the level of its fines was too low to prevent this. The reforms to its penalty policy are supposed to address this, but they have yet to be properly tested, and the credibility of enforcement has been damaged by a legacy of fines that were pitiful compared to the benefits banks gained from the misconduct. To provide greater incentives to maintain high levels of professional standards, both the FCA and the PRA should be prepared to review again their penalty setting framework in the future to allow for a further substantial increase in fines. They should ensure that in responding to any future failures they make full use of the new rules for calculating fines and build on the encouraging examples set by the LIBOR fines. If regulators believe that the current legal framework still inhibits them from imposing the necessary level of penalties, they should tell Parliament immediately.

In its Report on LIBOR, the Treasury Committee concluded that "the FSA and its successors should consider greater flexibility in fine levels, levying much heavier penalties on firms which fail fully to cooperate with them". We agree. Cooperation by firms in bringing issues to regulators' attention and assisting with their investigation should be a given. Regulators should make full use of the flexibility in their penalty policy to punish cases where this does not occur. However, regulators should also make it clear to firms that the same flexibility will be used to show leniency where inadvertent and minor breaches are swiftly brought to their attention and rectified, so that the fear of over-reaction does not to stifle the free flow of information.

A protracted process of enforcement with a firm can delay enforcement against individuals, weakening the prospect of its success and of meaningful penalties, particularly if the delay means that the individual can continue lucrative work for several more years and approach retirement. The Commission recommends that the regulators bear in mind the advantage of swift resolution of enforcement action against firms, in particular in cases where settlement with the firm is a precursor to action against responsible individuals.

Civil sanctions and powers of enforcement over individuals

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.

Later in this chapter, we consider the case for a new criminal offence specific to the banking sector. However, in the context of civil sanctions, the Commission has not heard the case advanced for a range of penalties which go beyond those already available. The problems, and the proposals for change which follow, reflect the fact that the sanctions already available to the regulators, such as very large fines and permanent disbarment from the UK financial services sector, have so rarely been applied.

The foundations for a new approach are laid in the Commission's recommendations in Chapter 6. In that chapter we recommended that a successor to the Statement of Principles in the form of Banking Standards Rules designed to ensure that the full range of enforcement tools could be applied to a wider range of individuals working in banking. This would be supported by a system of licensing administered by individual banks, under the supervision of the regulators, to ensure that all those subject to the Banking Standards Rules were aware of their obligations. This approach would prevent one barrier to effective enforcement that we identified, namely that regulators lacked effective powers to sanction misconduct by bankers who were not Approved Persons.

In Chapter 6 we made another proposal designed to address one of the most dismaying weaknesses that we have identified, whereby a combination of collective decision-making, complex decision-making structures and extensive delegation create a situation in which the most senior individuals at the highest level within banks, like Macavity, cannot be held responsible for even the most widespread and flagrant of failures. We proposed the establishment of a Senior Persons Regime to replace the Approved Persons Regime in respect of banks, whereby all key responsibilities within a bank would be assigned to a specific, senior individual. Even where certain activities in pursuance of the responsibility were either delegated or subject to collective decision-making that responsibility would remain with the designated individual. The Senior Persons Regime would be designed to ensure that, in future, it should be possible to identify those responsible for failures more clearly and more fairly. This should provide a stronger basis for the use of enforcement powers in respect of individuals.

These changes would also need to be accompanied by a change of approach from the regulators. In respect of insider trading, the increased effectiveness of criminal enforcement owes less to changes in the law than changes in the approach of the regulators, in particular to a realisation that a large-scale commitment of time, effort and resources to seeing cases through is both necessary and worthwhile. The same determination has not been so apparent in enforcement action relating to bank failures, LIBOR or mis-selling. At the root of this failure has been what the regulators themselves have characterised as a bottom-up approach. A key to success in the future is likely to be a top-down approach, drawing on the clarity that the Senior Persons Regime is intended to provide about who is exercising responsibility at the highest levels, what they knew and did, and what they reasonably could and should have known and done.

The proposal to create a rebuttable presumption that directors of failed banks should not work in such a role again is a well-intentioned measure for addressing the difficulty of proving individual culpability, but it is a blunt instrument with several weaknesses. The blanket imposition of a rebuttable presumption risks having perverse and unfair effects; it will act as a disincentive for new directors to come to the aid of a struggling bank; it could encourage power structures in which key decision-makers eschewed the title and responsibility of director. Furthermore, the Government proposal as it stands is too narrow to be of significant use. Notably, it would probably not have been triggered in most of the recent scandals ranging from the bail-outs of RBS and HBOS to PPI mis-selling and LIBOR manipulation. We have concluded that a more effective approach than the blanket imposition of a rebuttable presumption would be one which reverses the burden of proof in a wider, but clearly defined, set of circumstances covering both prudential and conduct failures.

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 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.

The FSA made the case for a power to impose an interim prohibition on individuals against whom enforcement action has been commenced. The case made by the FSA was not clearly targeted on banks. An interim prohibition could cause serious harm if used unfairly or arbitrarily. In the case of very small financial firms in particular, having a key individual prohibited for even a short period might cause irreparable damage to their reputation and see clients leave never to return, even though the case might be dropped or not upheld. Given that the FSA has only rarely taken public enforcement action against senior individuals in large banks, it may be that the cases through which they have identified the need for a suspension power involve smaller firms or non-bank financial institutions. Based on our consideration of issues relating to banking standards, the Commission has concluded that the case has not been made for providing the regulators with a general power to impose interim prohibitions on individuals carrying out controlled functions in the financial services sector.

The current time limit of three years between the regulator learning of an offence and taking enforcement action against individuals could act as a constraint on the regulators' ability to build credible cases. This could be a particular barrier to the regulators' ability to place greater priority on pursuing senior individuals in large and complex banks, as we are recommending. In view of our proposal that enforcement action against a firm must be completed before the regulator can deploy the new tool of a reversed burden of proof, more than three years may well be required to complete this process and make the new tool usable. The Commission recommends that the Government should address this problem by allowing for an extension of the limitation period in certain circumstances. However, swift enforcement action should be the priority. Regulators should be required retrospectively to provide a full explanation for the need to go beyond three years. They can expect to be challenged by Parliament if it were to transpire that they were using this measure as an excuse for delaying enforcement action.

A new criminal offence?

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.

It is inappropriate that those found guilty of criminal recklessness should continue to benefit from remuneration obtained as a consequence of the reckless behaviour. Fines may not claw back the full amount. The Commission recommends that the Government bring forward, after consultation with the regulators and no later than the end of 2013, proposals for additional provisions for civil recovery from individuals who have been found guilty of reckless mismanagement of a bank.

The Commission's support in principle for a new criminal offence is subject to an important reservation. Experience suggests that, where there is the possibility of a criminal prosecution, public disclosure of failings might be greatly limited until the criminal case is finished. It is important to expedite any civil sanctions against individuals and to publish information into banking failures in a timely manner. The Commission recommends that, following a successful civil enforcement action against a bank, the decision on whether to bring criminal proceedings against relevant Senior Persons must be taken within twelve months.

Enforcement decision-making

There is an inherent tension between the role of real-time regulators and the enforcement function, which can involve reaching judgements about matters in which supervisors were involved at the time. Regulators are also focused on the big picture, such as maintaining financial stability. Greater priority needs to be placed on the role of enforcement, with adequate resources devoted to this function 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.

A higher priority for the enforcement function could be achieved by replacing the Enforcement and Financial Crime Division of the FCA with a separate statutory body, which might also assume the enforcement functions of the PRA. However, we have concluded that to propose this change now would involve a new organisational upheaval for the financial services regulators, almost immediately after a major set of organisational changes have come into effect.

We have, however, concluded that the body responsible for making enforcement decisions arising from the work of the Enforcement and Financial Crime Division of the FCA, namely the Regulatory Decisions Committee, is not best-suited to the specific enforcement needs of the banking sector. At the moment, the Committee's composition seems to offer the worst of all worlds; it appears to contain neither a depth of banking expertise nor a clear lay element separate from banking and allied financial services sectors.

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 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. 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. The Commission further recommends 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.

In the UK, at the instigation of the chairmen of Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland, Santander, Standard Chartered and Nationwide,[6] Sir Richard Lambert is working on the development of a new self-regulatory regime for banking in a **Banking Standards Review**. In February 2014 he published a Consultation Paper seeking comments on an outline of proposed characteristics of such a regime. Here is an excerpt from the Consultation Paper:

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[6] Banking Standards Review, Consultation Paper, 2 (Feb. 2014) at http://www.bankingstandardsreview.org.uk/assets/docs/consultation-paper.pdf .

Prime responsibility for improving the conduct of banks lies with the leadership of the institutions themselves, operating within the framework set out by the regulators. But there is also a strong case for collective action in this area. Over the past 20 years, the norms of behaviour in important parts of the banking sector have fallen below what the public has a right to expect. The Salz Review of Barclays noted that "generally banks took too much comfort from some business practices being standard in the industry." More pithily, Warren Buffet observed that "The five most dangerous words in business may be 'Everybody else is doing it'." This is an industry where individuals frequently move from one firm to another. If the sector as a whole doesn't change its practices for the better, no reform effort by a single institution is likely to be enough to make an overall difference. Collective action will be required to raise general standards of behaviour. Incentives shape behaviour. In too many cases, industry norms have incentivised short-term revenue generation as opposed to the duty of care to customers. So long as this is allowed to continue, banking will fail in its efforts to raise standards of conduct. Absent industry-wide action, ever more intrusive regulation is likely. In the words of Sir Andrew Large and Sir David Walker, "If the industry does not volunteer standards...in areas where it knows that they could be effective, public officials have little alternative then but to try to write rules".

There is also a clear public interest in a collective approach to raising standards of conduct. A loss of trust in the banking sector as a whole has broad and damaging economic consequences. In addition, its role as an international banking centre is an important source of comparative advantage to the UK and to Europe, and one that would be damaged by a continuing wave of scandals. Moreover, an over-reliance on regulation will tend to reduce competition and build barriers to entry and innovation in the sector. The weight of existing regulation already makes it difficult for newcomers to break their way into areas like retail banking, where the large incumbent banks can spread the costs across all their activities. More and more rules would raise further barriers. Other countries have made collective moves in this area.[7] And there are examples in other industries of collective action being undertaken to address ethical problems....

The new organisation will need unquestioned credibility if it is to exert moral influence over the UK banking industry. Yet it will have no statutory powers and it will be funded by the banks themselves.

Its authority will have to be built on three strong pillars. One is a governance structure that guarantees its independence and integrity. The second is widespread participation across the banking sector. The third is credibility with a wide group of stakeholders–something that will take time to achieve.

The proposal is that a small panel, of perhaps four people, should be appointed to choose the chair and chief executive of the new organisation. We would expect the panel to retain an executive search firm. The panel might include a senior central banker, but no one from the commercial banking business itself, along with highly respected figures from other areas of public life. The chair would join the panel to help select the chief executive. All appointments, including the chair and the chief executive, would be publicly advertised and subject to the Nolan principles.[8]

The board itself would be small enough to be manageable, no more than 12 people including the chair. It would include bankers, to bring knowledge and credibility with the sector, but they would always be in a minority. Other members would bring a real understanding of a bank's full range of stakeholders–for example, people with experience as investors, members of consumer and employee groups, small business people and the like. It is important that board members should not act as representatives of particular interest groups, but rather work together in the overall interests of the board.

The board members would be paid.

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[7] Here he notes that "the Singapore Government has established Financial Industry Competence Standards to raise the quality and professional capabilities of the financial sector."

[8] See http://www.public-standards.gov.uk/ .

The choice of bankers will also be important. They will need to bring deep knowledge of different sectors of the industry, but there must be no conflicts of interest. Recently retired senior executives might be obvious candidates.

The board's credibility will rest upon its independence from the banking sector. This means that it should not act as an advocate for the banks. Its role must be completely separate from the British Bankers' Association and other trade bodies.

That raises a question about its accountability. To whom or what should it report? There is not a clear answer at this stage, and comments will be welcome in this consultation process.

A number of existing professional bodies in the financial services sector have Royal Charters, setting out that they are responsible to the public interest. This may not be an option, at least in the early years.

It would be helpful if the Treasury Select Committee took an interest in its proceedings, calling the chair and chief executive to account at least once a year in much the same way as the Health Select Committee calls in the General Medical Council on a voluntary basis.

In order to be credible with a wide group of stakeholders, the new organisation will need to be as transparent and open as possible. This will apply to the working of its board and of its standard setting processes, and to the way it accounts for its activities in its annual report and other publications. Its first priority at all times should be to the public interest.

One suggestion is that the board would be wise to balance the banks' funding by seeking financial upport from the many groups who consume bank services. But this seems unlikely to be forthcoming, and it is not obvious why customers should be asked to pay extra in order to be treated properly. Funding from banks and building societies will be on a proportionate basis.

The credibility of the new organisation will depend on widespread support by banks operating in the UK, whether British or overseas owned. The reason is that the case for collective action rests on the participation of a critical mass of banks and building societies of all kind.

The idea of setting up a body to promote higher standards in banking was supported by the Parliamentary Commission on Banking Standards and endorsed by HM Treasury.

The new organisation will plan its work in alignment with the regulators, and aim not to impose extra burdens of red tape. If successful, the reputation of the UK as a place to do banking will be enhanced. For all these reasons, it seems reasonable to expect that banks and building societies will find it in their interest to take part.

Winning the confidence of the wider group of stakeholders in the banking system will be challenging, and take time. This will be determined by the quality and breadth of the board, and the tone it sets in its public statements from the start....

Professional bodies such as those for doctors or lawyers have individual members. Many of them have been in existence for a very long time and have built up their credibility over generations. Many also have strong regulatory powers, up to and including the capacity to take away a member's licence to operate. Most of them are built on a common set of qualifications, even though their members may be undertaking very different activities: doctors have a common undergraduate training before they move on to their different specialisation. None of these conditi ons will apply to the new organisation

Very large numbers of people are employed by banks in the UK – more than 400,000 by the UK banks alone. Their qualifications, where they exist, are far from uniform. The ultimate sanction – to put an individual out of business – lies in the hands of the statutory regulator.

Trying to corral such a large and diverse group on a voluntary basis into a single new professional body starting from scratch with no track record would be very difficult. For all these reasons, the proposal is that the prime relationship for the new organisation at least in the opening years will be with the banks and building societies themselves, rather than with individual bankers. The banks and building societies will have to follow the guiding principles now being developed by the regulators, and these will also provide the basis for the standards set by the new organisation. So there will be alignment between the obligations of the banks and the objectives of the new organisation. And it will be for the banks to deal with misconduct by their own employees.

However, there are arguments for shifting over time towards individual membership. First, the sustainability of the new organisation would always be in doubt if it was wholly dependent on the goodwill of the banks and building societies.

Second, the ultimate goal must be to instil a sense of professional responsibility in the minds of individual bankers, making them aware of their obligations to society as well as to their manager or team leader. That is less likely to happen if employees' membership is at one remove, through their employer, rather than through their direct engagement. It is obvious that moving to a system of individual membership would be a big step, and one that could only be taken once the new organisation had achieved credibility, and shown that individuals could advance their careers by achieving membership. This should be the longer-term aspiration for the new organisation , as a second phase of its work. For the launch years, the proposal is that the new organisation will deal primarily with institutions rather than with individuals, and focus on its standard setting role...

The principle role of the new organisation is to set standards of competence and behaviour in order to improve customer service. In designing its standards, it will need to keep six points firmly in mind.

The first is that, for reasons already explained, this will have to be a collective effort if it is to have any chance of success.

The second is that one size will not fit all. High-level principles should cover the whole industry, but the skills required of a trader are obviously not the same as those of a branch manager.

The third is that there is no point in reinventing the wheel. Where good practices exist or are being developed, they should be encouraged and strengthened as opposed to being replaced by some new initiative.

The fourth is that nothing should be proposed that might impede the development of innovative new competition.

The fifth is that London is an international banking sector. Both the UK and Europe as a whole have a strong interest in its healthy development. So the free movement of talent in both directions must be maintained.

Finally, the process needs to be challenging – but it must also be kept simple. Box ticking processes have to be shunned. The new organisation should align its work with that of the regulators. So it should start off small, and only add to its activities as its credibility grows....

Standards set by the new organisation will be built firmly on the regulators' guiding principles. Banks are statutorily bound to act in accordance with these principles, so they will be obliged to meet or surpass these standards.

It would also be important to gauge the effective ness of training in this area. All banks have such programmes, but many seem to be of the box ticking variety. Faced with an on-line test on, for example, insider trading, the temptation is to complete the programme as quickly as possible, rather than give serious thought to the issues involved...

Standards of competence

A fundamental pillar of a profession is the existence of well-defined standards of competence. Long established professions like the law and medicine have minimum entry qualifications based on a body of knowledge defined by the regulating bodies...

Well defined competency standards have a number of benefits. First they demonstrate that individuals have the baseline level of competence necessary for their role. Second, qualifications also have ethical modules in their curriculum which help reinforce the social value of the profession and its responsibility to the public. Finally, they encourage professionals to abide by the code of conduct for fear that their hard won chartered status might be taken away...

Good practice on the part of the existing professional bodies should be supported, and competition among them encouraged. So the proposal is that the new institution should provide a canopy under which other professional bodies would continue to operate and grow. The new organisation will have an interest in ensuring that these bodies raise standards in the development, qualifications and the disciplining of their members. And it could provide a forum where these bodies could discuss common issues or raise concerns.

It could also accredit or validate their training programmes, which in turn means it will need to be able to influence their content where appropriate. For example, it will want to make sure that sufficient weight was given to ethical considerations, and that training covered the broad societal role of banks as well as the more detailed technical issues.

Of course this will require close working relationships with the existing and any future bodies, and perhaps some new governance arrangements. But that should not be impossible to achieve. In the end, it will be up to the members to decide whether they wanted such changes to happen.

Next come the in-house training programmes run by the banks themselves. Can these be rigorous enough to bring about the necessary changes? The Financial Services Consumer Panel has suggested not...

The proposal is that the organisation should... work with industry practitioners to set standards and accredit essential training for target populations. It should address a common weakness in the current arrangements, whereby individuals can gain technical expertise in their narrow area of speciality, but have no idea how this fits into the bigger picture. It should be made clear that qualifications do not by themselves lead to good conduct. That requires an understanding of the moral dimension in which businesses – especially banks – have to operate.

All these programmes, whether with the professional bodies or the banks' own training programmes, will need oversight from panels of practitioners with expertise in the different banking sectors. These panels will be coordinated and managed by the new organisation, but the judgments will have to be made by people with deep knowledge of the industry.

Banks are spending ever increasing amounts on in-house training, some of it of mixed quality. The new organisation should be a useful standard setter here. It might also be possible for banks to pool some of their training costs. The new organisation could help to design high quality training programmes to which all banks would have access.

Do you think this initiative is likely to be successful? The document identifies some issues to think about, such as the idea of competitiveness of London as a financial centre, and the question whether self-regulation should focus on firms or individuals or both. Did you identify other issues?

As part of its work the **Financial Stability Board** has focused on "Risk Culture."[9] Here is an excerpt from the FSB's Guidance on Risk Culture:

Weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events. A financial institution's risk culture plays an important role in influencing the

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[9] Financial Stability Board, Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture (Apr. 7, 2014) at http://www.financialstabilityboard.org/publications/140407.pdf .

actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders, including its supervisors.

A sound risk culture consistently supports appropriate risk awareness, behaviours and judgements about risk-taking within a strong risk governance framework. A sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks or risk-taking activities beyond the institution's risk appetite are recognised, assessed, escalated and addressed in a timely manner.

A sound risk culture should emphasise throughout the institution the importance of ensuring that:

(i) an appropriate risk-reward balance consistent with the institution's risk appetite is achieved when taking on risks;

(ii) an effective system of controls commensurate with the scale and complexity of the financial institution is properly put in place;

(iii) the quality of risk models, data accuracy, capability of available tools to accurately measure risks, and justifications for risk taking can be challenged, and

(iv) all limit breaches, deviations from established policies, and operational incidents are thoroughly followed up with proportionate disciplinary actions when necessary.

Risk culture, as well as corporate culture, evolves over time in relation to the events that affect the institution's history (such as mergers and acquisitions) and to the external context within which the institution operates. Sub-cultures within institutions may exist depending on the different contexts within which parts of the institution operate. However sub-cultures should adhere to the high -level values and elements that support the institution's overall risk culture.

First and foremost, it should be expected that employees in all parts of the institution conduct business in a legal and ethical manner. An environment that promotes integrity should be created across the institution as a whole, including focusing on fair outcomes for customers.

Supervisors should consider whether an institution's risk culture is appropriate for the scale, complexity, and nature of its business and based on sound, articulated values which are carefully managed by the leadership of the financial institution. In this regard, supervisors should set expectations for the board to oversee management's role in fostering and maintaining a sound risk culture. This requires supervisors to effectively articulate these expectations to the board and senior management and ensure ongoing follow-up on whether these expectations are being met....

Assessing risk culture is complex. But given its importance attention must be paid to it. There are several indicators or practices that can be indicative of a sound risk culture. Institutions and supervisors can build awareness of the institution's balance between risk-taking and control by considering such factors. These indicators can be considered collectively and as mutually reinforcing; looking at each indicator in isolation will ignore the multi-faceted nature of risk culture....

These indicators include:

• Tone from the top: The board and senior management are the starting point for setting the financial institution's core values and expectations for the risk culture of the institution, and their behaviour must reflect the values being espoused. A key value that should be espoused is the expectation that staff act with integrity (doing the right thing) and promptly escalate observed non-compliance within or outside the organisation (no surprises approach) The leadership of the institution promotes, monitors, and assesses the risk culture of the financial institution; considers the impact of culture on safety and soundness; and makes changes where necessary.

•Accountability: Relevant employees at all levels understand the core values of the institution and its approach to risk, are capable of performing their prescribed roles, and are aware that they are held accountable for their actions in relation to the institution's risk-taking behaviour. Staff acceptance of risk-related goals and related values is essential.

• Effective communication and challenge : A sound risk culture promotes an environment of open communication and effective challenge in which decision - making processes encourage a range of views; allow for testing of current practices; stimulate a positive, critical attitude among employees ; and promote an environment of open and constructive engagement.

• Incentives: Performance and talent management encourage and reinforce maintenance of the financial institution's desired risk management behaviour. Financial and non -financial incentives support the core values and risk culture at all levels of the institution....

Supervisors are in a unique position to gain insights on risk culture at financial institutions given their access to information and individuals across the institution, as well as the results of supervisory work. This unique view and the ability to gather observations across multiple institutions enable peer analysis and suggest issues that both supervisors and institutions should look at.

Supervisors should adopt a process to synthesise periodically supervisory findings, look for common themes, aggregate informal observations they have about the institution and apply high -level judgement in deciding whether culture or undesired behaviour is a root cause of supervisory findings. Supervisors should recognise that every supervisory activity can add information that informs these periodic assessments, but that single supervisory results are rarely a definitive indicator of culture issues that need to be addressed. Evidence should be gathered from the full range of supervisory activities so as to avoid the assessment of risk culture being perceived and managed as a compliance - driven exercise. The lists of possible indicators should be treated as a starting point for those assessments. Supervisors should avoid supervisory methodologies that treat these indicators as a checklist....

Discussions with boards and senior management will help form the supervisory view of the institution's risk culture. Supervisory observations on culture issues should be further discussed with members of the board and senior management so as to promote and develop a shared understanding of the institution's risk culture. Identification of a practice or attitude that is not supportive of sound risk management should be brought to the attention of the board or senior management, as appropriate, who have ultimate responsibility for outlining and overseeing the financial institution's risk culture, to influence change in a positive direction. The supervisor raising, and the financial institution acting early to address, the root causes of the behavioural weakness will aid in preventing (or mitigating the impact of) particular undesired cultural norms from taking root and growing.

Do you think that the FSB's focus on risk culture is different from the Parliamentary Commission on Banking's focus on culture? In what ways? Why do you think this may be? Do you think it is a good idea for supervisors of financial institutions to examine risk culture?