



House of Lords
House of Commons

Changing banking for good

Report of the Parliamentary
Commission on Banking
Standards

*Volume II: Chapters 1 to 11 and Annexes,
together with formal minutes*



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Parliamentary Commission on
Banking Standards

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First Report of Session 2013–14

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*Ordered by the House of Lords
to be printed 12 June 2013*

*Ordered by the House of Commons
to be printed 12 June 2013*

**HL Paper 27-II
HC 175-II***

Published June 2013

by authority of the House of Commons
London: The Stationery Office Limited

£0.00

Parliamentary Commission on Banking Standards

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

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The Commission's powers include the powers to require the submission of written evidence and documents, to examine witnesses, to meet at any time (except when Parliament is prorogued or dissolved), to adjourn from place to place, to appoint specialist advisers, and to make Reports to both Houses.

A full list of the Commission's powers is available in the House of Commons Votes and Proceedings of 16 July 2012 on page 266, and the House of Lords Minutes of Proceedings of 17 July 2012, Item 10.

Publications

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

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Volumes of this Report

This Report is the Fifth Report of the Commission (and the First Report of Parliamentary Session 2013–14). It has nine volumes:

Volume I: Summary, and Conclusions and recommendations

Volume II: Chapters 1 to 11 and Annexes, together with formal minutes

Volume III: Oral evidence given to the Commission

Volume IV: Written evidence given to the Commission

Volume V: Written evidence given to the Commission

Volume VI: Written evidence given to the Commission

Volume VII: Oral and written evidence given to Sub-Committees A and B

Volume VIII: Oral and written evidence given to Sub-Committees C, D, E, F and G

Volume IX: Oral and written evidence given to Sub-Committees H, I, J and K

Lists of witnesses who gave evidence and lists of people or organisations who submitted written evidence are given in the relevant volumes of the Report.

*House of Commons Printing Numbers

This Report is printed under House of Commons Printing number HC 175. It also incorporates papers ordered for printing in Session 2012–13 under the following House of Commons printing numbers:

HC 606-i to –xl, HC 619-i to –ii, HC 705-i to –viii, HC 783-i, HC 706-i to –v, HC 821-i to –iii, HC 710-i to –ii, HC 784-i, HC 881-i to –v, HC 804-i to –ii, HC 860-i to –iv, HC 945-i

Footnotes

In the footnotes of this Report, references indicated by 'Q' and followed by a question number refer to oral evidence taken by the Commission, published by the Commission in the third volume of this Report. References indicated by 'Ev' followed by a page number refer to written evidence published by the Commission in the fourth and fifth volumes.

References indicated by 'Q' preceded by a letter, for example, 'AQ' or 'BQ', and followed by a question number refer to oral evidence taken by the sub-committees of the Commission. For example, 'AQ' refers to oral evidence taken by sub-committee A: Panel on the consumer and SME experience of banks, and 'BQ' refers to oral evidence taken by sub-committee B: Panel on HBOS. There were eleven sub-committees and their evidence is published by the Commission in the seventh, eighth and ninth volumes of this Report.

References indicated by 'Ev' preceded by a letter, for example, 'A Ev' or 'B Ev', and followed by a page number refer to written evidence to the sub-committees of the Commission, published by the Commission in the seventh, eighth and ninth volumes of this Report.

References indicated by 'Ev' preceded by FR or TR refer to written evidence published online with the Commission's First and Third Report, respectively, and printed in the sixth volume of this Report.

Contents

Report Volume I	<i>Page</i>
Summary	8
Conclusions and recommendations	14
Report Volume II	
1 Introduction	82
2 The public experience of banks	85
Introduction	85
The bail-outs	86
Failing to serve customers	88
Introduction	88
Sales culture, cross-selling and mis-selling	88
Scandal after scandal	99
‘Masters of the universe’	102
Conclusion	104
3 The underlying causes	105
Introduction	105
This time is different	105
Incentives to become unmanageable	111
Too big to fail	111
Too big and too complex to manage	113
Loose federations of money-making franchises	115
Blinded by science	118
An accountability firewall	122
Paid too much for doing the wrong things	126
Falling bonuses, rising salaries	126
Payment by the wrong yard sticks	128
Incentives to mis-sell	130
Inadequate checks and balances	131
An absence of collective responsibility	131
Out of control	138
Regulation: barking up the wrong tree	142
Overview	142
A tendency towards rules and complexity	143
The role of supervisors	145
The quality of regulators	147
A lack of market discipline	148
Competition and standards	148
Concentration and choice	149

Barriers to entry	151
A mismatch of information	152
Incentives to pull in the wrong direction	154
The role of shareholders	154
Conflicts and complacency in external assessment	155
The wrong tax incentives	159
Levers of power	160
Insufficient downsides	161
Overview	161
Doing the decent thing	161
Regulatory penalties on individuals	162
Fines for firms	164
Conclusions	165
4 Tackling resistance to reform	166
Introduction	166
It's all under control	166
The aims of current reforms	166
Financial stability: a work in progress	168
Risks to the competitiveness of the UK banking sector	172
Overview	172
International competitiveness	174
European obstacles	183
Shadow banking	185
Biting the hand that feeds us	188
Capital and lending	188
Attractiveness of banks for investment	189
Overcoming resistance	192
5 Better functioning markets	193
Introduction	193
A vital utility role	193
Serving vulnerable members of society	193
Underpinning utility provision	195
Community finance and poorly-served communities	199
Competition in retail banking	202
Introduction	202
Competition and standards	202
Direct measures to reduce concentration	204
Barriers to entry	206
Alternative modes of provision	215
Peer-to-peer and the rise of the internet	217
Bringing alternative providers into the regulatory orbit	220
Enabling customer choice	223
Introduction	223
Common utility platform	224
Account portability	226
Seven-day switching service	228

Switching fee	229
Assessing the options	231
A market investigation reference	233
Tackling the information mismatch	240
Introduction	240
Duty of care	241
Empowering consumers through service standards	244
Tackling the legacy of RBS	247
Background	247
Rebuilding the balance sheet	248
The effects of public ownership	253
RBS's current strategy	256
Obstacles to early disposal	257
Other strategies	259
A 'good bank / bad bank' split	260
Challenges in creating a bad bank	263
Full break-up	268
Conclusions	269
Lloyds Banking Group	270
Financial literacy	273
Complaints and redress	276
Small business access to the Financial Ombudsman Service	276
The industry's approach to PPI complaints management	278
Handling fees for complaints	280
Transparency in wholesale and investment banking	280
6 A new framework for individuals	283
The contribution of governance	283
Taking individual responsibility	283
The Approved Persons Regime	283
Overview	283
The statutory framework for approval	284
The controlled functions	284
The approval process	285
The Statements of Principle for Approved Persons	286
Relationship to the Remuneration Code	287
What's wrong with the Approved Persons Regime	288
A narrow scope	288
Absence of individual responsibility	289
A one-shot approach	291
Bureaucratic complexity and inertia	291
Conclusions: the failure of the Approved Persons Regime	293
The role of professional bodies	294
Is banking a profession?	294
Qualifications and training	295
Standard setting and codes of conduct	298
Discipline and control	300
Lessons from other sectors	302

Making a choice	304
Milestones for a professional body	306
Our approach	306
Codes of conduct and enforcement	307
Participation by banks	307
Scope	308
Training and continuing professional development	309
Funding and independence	309
The Senior Persons Regime	310
Three new pillars	310
A new regime	311
Defining scope and responsibilities	312
Entry, review and conditions	314
The Licensing Regime	315
Broadening the regime	315
Making banks responsible	317
Reforming the register	320
The benefits of an international approach	322
Banking as a special case	323
7 Bank governance, standards and culture	324
Introduction	324
Shareholders: the silent owners	324
The UK equity market	324
Who owns the banks and why?	326
Shareholder pressure and leverage	326
Conclusions	327
The role of bondholders	327
Bank boards and governance	330
Introduction	330
The nature of the failures	332
Why banks are different	333
Fiduciary duty	342
Conclusions on boards	343
Individual responsibility	344
Internal controls and disciplines	347
The problem	347
Front-line controls	349
Risk management	350
Compliance	351
Internal audit	354
Conclusion on internal controls	356
Standards and culture	356
Introduction	356
Prospects for rapid change	356
Bank codes of conduct	358
Tone at the top, middle and bottom	361
Individual incentives for improvements to standards and culture	363

Indicators of changed culture	365
Driving out fear	365
Introduction	365
Reasons the banks were not told by their own employees	366
Encouraging escalation and whistleblowing	368
Banks' own whistleblowing policies	369
The role of the regulator	373
8 Remuneration	377
Introduction	377
Rewards out of kilter	377
Introduction	377
The one-way bet	378
Harvesting the fruits of market distortion	381
Banks will not solve this themselves	384
The current policy framework	390
Fixed and variable remuneration	391
Yardsticks for variable remuneration	394
Company financial performance	394
Incentives for retail sales	396
Conclusions	397
Reforming variable remuneration	398
Deferral	398
Recouping variable remuneration	400
The instruments of variable remuneration	402
Conclusions and recommendations	403
Board remuneration	407
The international dimension	408
Getting it done	410
A new Remuneration Code	410
Transparency and reporting requirements	411
The role of banks and their owners	413
9 Regulatory and supervisory approach	414
Introduction	414
New regulatory architecture	414
Regulatory failure	415
Introduction	415
Shortcomings of prudential regulation and supervision	415
Dangerous global distractions	417
Conduct failings: missing the bigger picture	418
Mired in process	419
The wrong level of engagement with banks	421
Quality of supervisory staff	421
Conclusions	422
Real-time supervision	422
Introduction	422
PRA's supervisory approach	424

FCA's supervisory approach	427
Supervisory relationship with banks	432
Special measures	435
Supervisory resources	438
Staff	438
Raising historical awareness	441
Cost of regulation	442
A role for senior bankers?	443
Regulatory Framework	444
Basel III and Europe	444
Capital	448
Leverage	449
Aligning tax rules with regulatory objectives	453
Inappropriate tax incentives	453
Options to achieve tax neutrality	455
Accounting for regulatory needs	458
Introduction	458
Accounting issues particular to banks	459
A separate accounting regime	460
Clearer auditors' reports	463
It's good to talk	465
The new regulatory structure and our approach	469
Regulatory objectives	473
A PRA competition objective?	473
The FCA: too many objectives?	474
Embedding a pro-competition culture at the FCA	476
Regulatory accountability	478
Introduction	478
A better run Bank of England	479
Financial Conduct Authority	482
Retrospective regulatory reviews	483
Conclusions on regulatory accountability	485
The new responsibilities	487
Physician, heal thyself	487
Warnings from history	488
10 Sanctions and enforcement	489
Introduction	489
Senior Persons Regime	489
Licensing	490
Reforms to remuneration	490
Enforcement against banks	491
The current approach	491
The level of fines for banks	493
Conclusions	495
Enforcement against individuals	497
The need	497
The sanctions currently available	499

Evidential standards and individual culpability	500
The approach to enforcement	502
Enforcement of civil sanctions: proposals for reform	503
Rebuttable presumption	503
Interim prohibition	507
Changing the limitation period	508
Civil sanctions and powers of enforcement over individuals	509
Why action is needed	509
Paving the way for a new approach	509
Taking responsibility	510
A new criminal offence?	512
A new offence: the need	512
The Treasury consultation	512
The standard for a new offence	513
Practical considerations	514
A punishment that fits the crime	515
Conclusions and recommendations	516
Enforcement decision-making	517
The challenge	517
FCA enforcement and the Regulatory Decisions Committee	517
PRA enforcement	519
Cooperation between the regulators	520
Conclusions and recommendations	520
11 The way forward	523
Annex 1: Conduct of our work	525
Annex 2: Trust in other sectors	528
Annex 3: Bank remuneration	530
Annex 4: CDFIs	531
Annex 5: Bank ownership	533
Annex 6: The public policy framework for remuneration	535
Formal Minutes	540
List of witnesses and published written evidence taken by the Commission	541
List of witnesses and published written evidence taken by the Panels	553

1 Introduction

1. 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.¹ 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.

2. The exposure of the scandal of the manipulation for private advantage of the London Interbank Offered Rate (“LIBOR”) in late June 2012 took public trust and confidence in UK banks to new depths. The LIBOR scandal served as the final straw for the public and Parliament because the behaviour exhibited seemed to encapsulate so much that appeared to have gone wrong in banking, before, during and after the financial crisis, reflecting both poor individual and corporate standards of conduct. The industry was not just revealed as incompetent, but appeared morally bankrupt.

3. In the days following the revelations, there was intense, and at times heated, debate about the best form of inquiry to tackle public concerns about banking. From this debate emerged signs of a growing acceptance that standards in banking were low, that a wide-ranging examination of them was needed, and that, following such an examination, far-reaching reforms would be required. Both Houses of Parliament agreed to establish this Commission “to consider and report on [...] professional standards and culture of the UK banking sector”.² We were encouraged in the course of the debate in the House of Commons not to adopt a narrow approach to our task.³ The way in which we have carried out our work is considered in Annex 1.

4. Banks have a crucial role in the economy. Banks provide, amongst other things, a safe store for deposits, credit for individuals and businesses and the infrastructure for payments and transactions within the economy. As Sir Mervyn King, Governor of the Bank of England, told us, “the economy cannot really function without a basic banking system”.⁴ The United Kingdom has also for many decades continued to thrive and develop as a global financial centre, and banking has made an important contribution to that development.

5. Trust in banking is at a low ebb. This collapse of trust in banking has been mirrored to some extent in other sectors, as discussed in Annex 2. However, the loss of trust in banking is more serious and pernicious for at least three reasons. First, the public as taxpayers have

1 National Audit Office, HM Treasury Resource Accounts 2011-12, The Comptroller and Auditor General’s Report to the House of Commons, July 2012, p 91

2 HC Votes and Proceedings, 16 July 2012, p 266; HL Minutes of Proceedings, 17 July 2012, item 10

3 *Ibid.*

4 Q 4561

footed and are still footing the bill for some of the behaviour which led to the loss of trust. Second, the events which led to that loss were the result of pervasive structural weaknesses, rather than the failings of a few individuals. Third, and most important of all, trust is necessary for banking to function at all. Lloyds Banking Group set out why:

Trust goes to the heart of what banking is about. Customers need to be able to trust their bank to look after their savings. They need to trust their bank to manage their financial transactions smoothly; trust that their bank will be diligent and not provide levels of credit or mortgage that are more than the customer can re-pay; and trust their bank to provide products that genuinely meet the customer's needs and which the customer can understand. In commercial banking, sound businesses need to know that their bank will be with them through difficult as well as good times and will not suddenly change terms or withdraw support.⁵

Loss of trust in banks also damages the UK as a major financial centre. TheCityUK wrote:

The sustainability of the UK's position as the pre-eminent global financial services centre is grounded in the integrity of its financial markets and probity of market participants.⁶

Furthermore, as Richard Sermon MBE, Chairman of The City Values Forum in the City of London, has noted, "Trust and confidence are hard won and are easily and quickly lost—trust arrives on foot but departs by Ferrari".⁷

6. 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.

7. 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.

8. 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

5 Ev 1216

6 Ev 1364

7 Caux Initiatives For Business, *Trust and Integrity in the Global Economy*, 2012, p 9, www.cauxbusiness.com

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. Much of this Report is about how that should be done.

9. Unless the implicit taxpayer guarantee is explicitly removed, the task of improving banking standards and culture will be immeasurably harder. The principal purpose and effect of the post-banking crisis measures now being implemented, both the requirements of Basel III and through the Banking Reform Bill, is to make it less likely that banks will fail. That is all to the good. But it cannot guarantee that there will never be a major bank failure. It is important to make it clear that, should such a failure occur, the bank should be allowed to fail. That is to say, while both the payments system and insured depositors will be protected, there should be no bail-out of a bank.

2 The public experience of banks

Introduction

10. Even in the context of a fierce political debate about how best to respond to revelations about LIBOR manipulation, one thing appeared to unite the Chancellor of the Exchequer and his Shadow: that the public were angry. Rt Hon Ed Balls MP spoke of the “massive public anger that has erupted”.⁸ The Chancellor said, “let us at least acknowledge that the public are very angry about what happened [...] That is presumably an area of agreement between us”.⁹ At this point, the extent to which anyone had suffered directly from LIBOR manipulation was unclear—press reports published shortly after the manipulation suggested that there would be both winners and losers from the manipulation in pure monetary terms—and therefore, considered as an isolated incident, the force and magnitude of the outcry that followed might seem disproportionate.¹⁰

11. Banks perform an essential function in a modern economy. They act as financial intermediaries between lenders and borrowers, and have an essential role in sustaining capital markets. They enable entrepreneurs to start businesses and families to buy their homes. The overwhelming majority of people working in banks undoubtedly wish to serve their customers well and are as angry as the wider public about the activities of a minority of their colleagues and some of the difficult positions in which they were placed by flawed structures within banks. As well as hearing from a number of senior bank employees during the course of our work, we also met front-line staff. We were impressed by their sincerity and their desire to serve their customers.

12. The public anger about LIBOR manipulation should be seen in the context of the fact that for years, failure had followed failure in banking, and scandal had followed scandal. All the while, the architects of those failures and scandals appeared to continue to enjoy elevated wealth and status, with no one called to account. This chapter considers the tip of the iceberg of which revelations about LIBOR manipulation were the most visible: the public experience of banking. The next chapter considers what lies beneath the water’s surface: the causes of the deficiencies in banking standards, of which LIBOR is only one consequence. In this chapter we first consider briefly the effect of the financial crisis on public attitudes towards banks, before going on to discuss the effect of issues relating to how banks relate to their customers. We then consider some of the conduct scandals that have been widely reported. This chapter seeks to explain why the reputation of banks and banking has been so tarnished in the eyes of the public, leading to a loss of trust in the sector.

8 HC Deb, 5 July 2012, Col 1112

9 HC Deb, 5 July 2012, Col 1130

10 See for example, “LIBOR: Who lost out when the rate was fixed?” *BBC*, 14 July 2012, www.bbc.co.uk

The bail-outs

13. The knowledge that the taxpayer bailed out banks during the financial crisis casts a long shadow over the public's view of banking. Ipsos Mori submitted that their research demonstrates that "Seemingly, British attitudes towards banks are shaped by the 2008 financial crisis and the bailout of the financial institutions by taxpayers".¹¹ An example of this kind of attitude is given in evidence from two bank consumers, who wrote that "In some cases [bankers] have walked away with millions of pounds of shareholder and taxpayers' money when they should have gone to jail."¹² The union for Lloyds employees, Accord, also made the link between the bail-out and public attitudes to banks, reporting that "in the wake of taxpayers' money being used to recapitalise the incipient [Lloyds Banking Group], the level of abuse they received from customers increased dramatically".¹³

14. The knowledge that the public have paid to keep banks in business appears to give rise to an expectation of some kind of reciprocal response from the banks, which has been lacking. CRESC noted that:

The taxpayer has ploughed enormous sums of money into rescuing the banking system. Northern Rock, RBS and Lloyds TSB, have received direct bailouts, but all banks have benefited from other forms of public subsidy, in particular Quantitative Easing (QE) and deposit guarantees. Public support has not, however translated into banks acting in the public interest.¹⁴

The British economy continues to flounder. Businesses and others rely on banks to support their economic prosperity. A case study in Scotland revealed the enormous impact on people's lives that a change in a bank's approach to lending could have (see Box 1). We heard dramatically different stories from banks and businesses about banks' willingness to lend to small and medium-sized businesses. Although evidence is mixed, what emerged clearly during our evidence-taking was a perception in the business community that banks were seeking to withdraw lending from some small businesses, or are pricing credit at a rate which would be akin to withdrawing lending.¹⁵ Even though the banks dispute that they were acting in this way, such a perception impacts heavily on business confidence and willingness to invest. Mike Spicer, Senior Policy Adviser, British Chambers of Commerce, suggested that difficulties faced by new, small businesses in accessing finance represented a missed opportunity for the economy, because these were "companies that provide or would provide a real kick to employment growth".¹⁶ Barclays acknowledged that this wider impact of the financial crisis, beyond taxpayer bailouts, was also causing public anger:

Not all banks required taxpayer rescue during the last crisis. But there is no doubt that the aggregate impact on the economy has been widespread and indiscriminate. Despite significant distinctions in the way different banks fared through the credit

11 Ev 1164

12 Ev 1393

13 Ev 738

14 Ev 1416

15 I Ev 8

16 AQ 43

crisis, the public's verdict was clear: banks made mistakes and taxpayers have paid the price.¹⁷

Box 1: Case study: Housing Associations in Scotland

The Commission's Panel on Scotland took evidence from the Highlands Small Communities Housing Trust (HSCHT) and the Scottish Federation of Housing Associations (SFHA). The Panel was told that changes to the terms on which banks would offer credit had had a significant detrimental effect on communities:

What we are finding now is that the families in the rural areas cannot access self-build finance. The banks have changed their criteria substantially; [...] It makes it very difficult now, if not impossible, for self-build in general, never mind subsidised self-builds, which can be classed as affordable. In rural Highlands, self-build is one of the few ways of providing affordable housing.¹⁸

Written evidence from the SFHA described some of the problems with accessing finance from banks that housing associations had faced:

A considerable tightening of terms and conditions[; ...] New term loans are for a typical maximum of 5 years with an option to renew, as opposed to a guaranteed 30 years[; ...] Attempts to link previous loans with new money, to refinance longer term loans which may now be less profitable to the Banks[; ...] Much higher loan margins and fees—often 2.5 per cent to 3 per cent above LIBOR and increasing—6 per cent has been seen on a deal involving a subsidiary[; ...] Tortuous time scales and processes involving distant credit committees and unclear procedures mean a lack of certainty.¹⁹

Ronnie MacRae described the wider impact of these changes on small communities:

One or two houses in a small community generates a lot of economic benefit to that community: there are the shops, the schools, employment for various trades. Even in the centres, there are the planners, the bankers themselves, they are losing staff in Highland now because their self-build mortgages are going. The impact on the Highland economy in general is going to be severe. In 2007, there were 650 individual houses, which would be self-procured, if not self-built. [...] the number has dropped substantially, and when you look at the impact that has on small, rural communities—even if it is one or two houses—it is significant. On the social side, what is happening is if young families, once they get married, cannot get affordable housing in their own communities they have to look elsewhere, most likely at the centres, Inverness, Dingwall, or somewhere like that.²⁰

17 Ev 799

18 IQ 32

19 I Ev 35

20 IQ 41

Failing to serve customers

Introduction

15. Most people deal with at least one bank in their day-to-day lives. The Financial Services Consumer Panel submitted that:

The Panel feels the seriousness of the detriment experienced by many banking customers should not be underestimated. Holding and operating a bank account has become essential to participating in a modern society. For many consumers this has left them vulnerable to poor practices. Unsurprisingly, the inconvenience and disadvantage felt by many banking customers has led to worryingly low levels of trust in UK banks.²¹

The public's opinions on banks will be based on their direct experiences as well as what they read about banks in the papers. However, Ipsos Mori explained that:

The correlation between the average level of familiarity with banking companies and their net trust score shows a high correlation. In other words, the more a person knows a bank, the more likely they are to have confidence in it. However, there is an exception to this rule. It does not apply if familiarity is the result of exposure to negative news coverage, which is the case for the banks most associated with the financial crisis of 2008, and is likely to be the case for ensuing banking scandals.²²

This suggests that even where they encounter good service in their own bank, multiple reports of failures to serve customers may reinforce the public view that banks cannot be trusted. The most troubling examples of this are the recent mis-selling scandals, but as the Financial Services Consumer Panel suggested:

Beyond the well publicised mis-selling scandals, there are numerous examples where banks are failing to treat their customers fairly by, for example, failing to meet basic standards designed to protect consumers.²³

Sales culture, cross-selling and mis-selling

16. Banks have been plagued with accusations of mis-selling to customers for many years. These incidents have affected the public experience of banking in two ways: directly, in that a large number of customers were mis-sold products, and indirectly, in that the scandals entered the public consciousness.

Customer experience

17. Even before the term “mis-selling” was widely reported, consumers and businesses may have felt the effects of the culture in which the scandals originated. Consumer groups and business representatives described a feeling amongst customers that banks were trying to

21 Ev 1026

22 Ev 1167

23 Ev 1024

make as much money as possible from them, rather than meet their needs. Peter Vicary-Smith referred to customers being subject to “hard-sell techniques.”²⁴ In a recent speech, Bill Michael, UK Head of Financial Services, KPMG, said that banks “treat customers like captive geese. Captive geese that can be force fed, or sold more product to – whether appropriate or not.”²⁵ Indeed, this can be demonstrated by the common lenders’ acronym ‘CAMPARI and ICE’, which is often used by those who teach bank staff about the fundamentals of lending to clients. The E of ICE usually represents “Extras”. The IFS School of Finance course book for Corporate Commercial and Business Lending suggests bank staff note the following points in respect of “Extras”: “Are there other products [...] which might be offered to the customer? [...] To a certain extent, customers can be ‘locked in’ by purchasing services from their bank”.²⁶ Practices began to emerge whereby customers went into banks to buy a product or service, for instance a mortgage or a loan for their business, and found themselves leaving with additional products, sometimes after considerable pressure, or sometimes after a sleight of hand by bank staff. Two types of product that were ‘cross-sold’ in this way are payment protection insurance and interest rate hedging products (see Box 2).

Box 2: Cross-selling and mis-selling

Payment Protection Insurance²⁷

Payment protection insurance (PPI) is an insurance product designed to protect a borrower’s ability to maintain credit repayments in the event that the borrower becomes unable to maintain the repayments due to accident and/or sickness and/or unemployment and, under some policies, death. PPI was sold alongside many credit products, including mortgages, unsecured personal loans, credit cards and bank account overdraft facilities.

PPI was paid for by customers through either a single or a regular premium and these were defined by the Competition Commission as follows:

- (1) Regular Premium: A series of payments of the premium made on a continuing basis and at regular intervals, usually monthly, over the term of the PPI policy.
- (2) Single Premium: A single payment, made up front, whereby the insurer is paid the full price for taking out a PPI policy in one lump sum (as opposed to receiving a regular premium each month).

The Competition Commission’s 2009 report on PPI concluded that the sale of single premium PPI policies should be prohibited.²⁸

24 AQ 1

25 “*The Future of Banking: Challenges and Opportunities*”, speech by Bill Michael to the BBA Banking Conference, October 2012

26 *IFS School of Finance, Corporate Business and Commercial Lending – Stage 1, 2008*

27 Competition Commission, *Payment Protection Insurance Market investigation*, 29 January 2009

28 J Ev 244

Interest Rate Swaps

Interest Rate Swaps (IRS), also known as Interest Rate Hedging Products (IRHP), sold in conjunction with a floating rate loan are usually designed to provide the customer with a degree of certainty on the interest rate that the customer will be charged throughout the lifetime of that loan. Abhishek Sachdev explained:

A loan with a swap is designed essentially to give a business a fixed rate of interest. A loan is typically payable at a variable rate—in the UK, that is going to be against three-month or one-month LIBOR, or against base rate—and then, to protect the business against rising interest rates, they enter into a separate derivative contract, which is an interest rate swap. That essentially compensates the business in case interest rates go up, and if interest rates go down they actually have to make extra payments on the swap, so it gives them a fixed rate.²⁹

There are different types of interest rate swap and the complexity of a swap varies according to the way it is structured. The FSA explains that:

There are broadly four types of [IRS] products that have been sold to customers: **swaps** – enabling the customer to ‘fix’ their interest rate;

caps – placing a limit on any interest rate rises;

collars – enabling the customer to limit interest rate fluctuations to within a simple range; and

structured collars – enabling a customer to limit interest rate fluctuations to within a specified range, but involves arrangements where, if the reference interest rate falls below the bottom of the range, the interest rate payable by the customer may increase above the bottom of the range.³⁰

18. ‘Cross-selling’ refers to the practice of using the opportunity of contact with a customer who is buying one product to sell them another product. This is a common practice in many industries: when a customer goes into a shop to buy a computer, the saleswoman may also try to sell her a printer. On its own, this practice is not problematic. However, in retail banking, some cross-selling practices became inappropriate, with undue pressure put on customers to buy the additional product, sometimes with the products taken together being presented as the only option or indeed customers not being told that they were purchasing an additional product. Abhishek Sachdev, of Vedanta Hedging, described this kind of practice when banks sold IRHPs to businesses:

[banks] can say, “You are not allowed to have this loan unless you do the hedge.” Sometimes, this is introduced quite late in the process. You have spent two or three months going through the whole process, the credit approval and all the bits and

29 AQ 86

30 FSA, *Interest rate hedging products Information about our work and findings*, August 2012, www.fca.org.uk

pieces that the bank requires you to do and then, sometimes at the last minute, the bank may say, “But we have to have some hedging.”³¹

19. The interest rate swap scandal has cost small businesses dear. Many had no concept of the instrument they were being pressured to buy. This applies to embedded swaps as much as standalone products. The response by the FSA and FCA has been inadequate. If, as they claim, the regulators do not have the power to deal with these abuses, then it is for the Government and Parliament to ensure that the regulators have the powers they need to enable restitution to be made for this egregious mis-selling.

20. As with the IRHP sales process, in the case of insurance products sold alongside credit products, there was only one opportunity for the bank to sell the insurance product: at the point at which the credit product was sold. Banks told us that if the PPI product was not sold to the customer, the bank would make a loss, or very low profit margins, on that loan. In essence to make any significant profit from the customer in this one-shot opportunity, the banks had to ensure the customers bought the PPI product. In their written evidence to us, RBS said that:

for much of the period in question, personal loan rates were so low that they did not (alone) cover the cost of credit for the customer. In other words, the low personal loan rates for all customers would not have been possible without the cross-subsidisation from PPI sales to some customers.³²

Eric Daniels, former chief executive of Lloyds TSB, told us, “There is no question that the rate on credit cards and personal lending was far below the economic value of those products”.³³ He also noted that “Personal lending, when looked at in isolation, did not give an economic return, because the APRs were so low. The PPIs did give a higher return, but the combined basket was still very low, and we looked at it on a combined basis”.³⁴ This was also a feature of the way in which products were designed: Paul Geddes, Chief Executive of Direct Line Group, RBS and former CEO of UK Retail Banking, RBS said of PPI that “we saw the profitability of this product integrally with the profitability of personal unsecured lending” and added that “we did see the fact that customers were effectively buying a protected loan”, suggesting that there was an expectation from the bank that the customer would buy both products.³⁵ This may have contributed to the pressure that was placed on customers. Natalie Ceeney, Chief Executive, Financial Ombudsman Service (FOS), described sales practices in relation to PPI:

A consumer would say, “I really don’t want PPI,” but the reply would be, “I’m sure you do. It’s really in your interest,” and that would go on four or five times. We have heard some scripts where “pushy” is mild as a description of the sales approach.³⁶

31 AQ 130

32 J Ev 204

33 Q 4260

34 Q 4269

35 JQ 326

36 JQ 712

21. While the banks were aware that they had to sell PPI in order to make meaningful profit from customers they sold loans to, the FSA did not “appreciate the full extent of the profit made by a few high-street retail banks” and “lacked the capability to do market wide analysis which could have informed our thematic work”.³⁷ Mr Briault explained that:

The FSA in the preceding years, not specifically about PPI, but the FSA board, and as communicated originally...from Howard Davies as joint chair and chief executive of the FSA, took an approach based on the mantra of “We are not a price regulator”. So the fact that the market was uncompetitive and as a result some consumers were paying much higher prices than they needed to pay was not necessarily something which the FSA would have picked up as being in itself mis-selling. There was nothing in the ICOB rule book which said you may not charge more than £x,000.³⁸

There were inconsistencies in the evidence provided to the Commission by major retail banks and their former executives. They maintained that PPI was both a product designed to meet “customer needs”, but also provided “cross-subsidies” to keep personal loan and credit card interest rates down. The business models put in place by senior banking executives for PPI and IHRPs relied on the one-shot cross-selling opportunities of these products to deliver profits to their banks to make up for loss-leading credit product sales. The FSA did not take appropriate account of the detrimental implications that this type of business model could have for customers. In relation to PPI, instead of taking decisive action, they waited for the Competition Commission to finish its two-year long inquiry.

Mis-selling in the public sphere

22. The first consumers might have heard of mis-selling by banks is a ‘super-complaint’ about PPI mis-selling brought by Citizens Advice in 2005 to the Competition Commission, although both Citizens Advice and Which? told us that they had been raising concerns about PPI for some years before that date, and the FOS raised concerns in April 2001.³⁹ However, evidence suggests that it was in the period 2006 to 2007 that it first came to the attention of the public at large. Natalie Ceeney told us that:

We had fewer complaints in the whole of 2007 than we now have in three days about the operation of PPI. The volumes before 2007 were tiny[...] they were mostly about claims. What happened around 2006-07 was the big publicity—there was the super-complaint, all the consumer groups started talking about it and there were the Competition Commission and the OFT inquiries—so the volume went up.⁴⁰

23. When the FSA took over regulation of PPI in 2005 it was “included in the same general FSA requirements for lower risk insurance products, which the FSA believed would be sufficient to address concerns about specific poor selling practices raised in the

37 J Ev 255

38 JQ 165

39 JQq 3, 23; FOS, *Ombudsman News*, Issue 4, April 2001, www.financial-ombudsman.org.uk

40 JQ 696

consultation”.⁴¹ In January 2005, the FSA conducted its first thematic review. The results were published in November 2005 and found that poor sales practices existed and that compliance standards in respect of the sale of PPI alongside loans and credit cards were generally weak.

24. Two further thematic reviews were conducted by the FSA. In October 2006 it found “major weaknesses which go to the heart of the culture surrounding PPI sales [...] the industry has further to go to demonstrate that customers really are being treated fairly in this market”.⁴² Its 2007 work found “little or no improvement in the disclosure to customers of price and policy details, or about the eligibility and suitability for the customer”.⁴³ Two-thirds of the firms visited and nearly all of the firm’s mystery shopped failed to satisfy the ICOB requirements.⁴⁴

25. Separately, the OFT and the Competition authorities were undertaking investigations into the PPI market. The OFT responded to the super-complaint in 2005, and began its market study in 2006, completing it in October 2006 and eventually referring the market to the Competition Commission in February 2007.⁴⁵ In January 2009, following a 2-year inquiry, the Competition Commission published its report recommending a ban on single premium PPI and a prohibition on banks selling PPI alongside credit products. This decision was challenged by Barclays and Lloyds banking group in the Competition Appeal Tribunal (CAT). The CAT did not question the conclusions regarding the lack of competition in the PPI market but required the Competition Commission to conduct further evaluation as to whether the point-of-sale ban might inconvenience customers.⁴⁶ After further analysis, the Competition Commission re-submitted its conclusions.⁴⁷ These eventually came into force in April 2012, 18 months after the date originally proposed.

26. The FOS formally wrote to the FSA to draw its attention to the “wider implications” of the complaints it was investigating about PPI in July 2008. In August 2010, the FSA published Policy Statement 10/12, outlining the approach which firms should take to the assessment and redress of PPI complaints. This all added to a general picture that wrongdoing had been committed by banks.

27. Despite this negative impression, the British Bankers’ Association (BBA) chose in 2010 to bring a judicial review action against the FSA and the FOS. This related to:

the FSA’s new payment protection insurance (PPI) complaints-handling measures that came into force on 1 December 2010 and;

41 J Ev 259

42 J Ev 258

43 J Ev 260

44 J Ev 258

45 J Ev 268 - 269

46 Competition Appeal Tribunal, *1109/6/8/09 Barclays Bank plc v Competition Commission*, 16 October 2009, www.catribunal.org.uk

47 “PPI-CC confirms point-of-sale prohibition”, Competition Commission News release, 14 October 2010, www.competition-commission.org.uk

information on [the FOS] website about the approach [the FOS took] to consumers' complaints that they have been sold PPI policies inappropriately.⁴⁸

Angela Knight CBE, Chief Executive of the BBA at the time of the judicial review, told us of her “grave concerns” about bringing the action, and acknowledged the possible reputational consequences for the banking industry of doing so:

given the nature of the situation at the time, given the very high attention on PPI and the fact that there were some really serious issues out there, I could not personally see that a case was necessarily going to do anything in that respect.⁴⁹

Ms Knight and others told us that the judicial review had been a last resort after attempts to resolve the issue with the FSA failed. The BBA told us in their written evidence that the BBA retail committee “unanimously” supported the judicial review.⁵⁰ During the period of the judicial review, a number of major high-street banks put consumers' complaints on hold and refused to process them. This led to a large backlog of complaints when the banks lost the judicial review, causing delays for customers. The High Court found against the BBA, and provision for the cost to banks of redress currently stands at over £12 billion.⁵¹

28. Major banks and some senior banking executives remain in denial about the true extent of PPI mis-selling. Over a significant period of time they ignored warnings from consumer groups, regulators and parliamentarians about PPI mis-selling. They used legal challenges to frustrate and delay the actions of the FSA, the FOS and the Competition Commission. Rather than upholding high levels of professional standards, senior executive pursued a box-ticking approach to compliance, adhering only to the specifics of their interpretation of the regulator's detailed rules in this area, rather than pursuing an approach to selling PPI that was truly in keeping with the spirit of the FSA's requirement that firms have a duty to treat their customers fairly. The IRHP and PPI mis-selling debacles both highlight how banks appeared to outsource their responsibility to the regulator; banks must not be allowed to do to this again if future scandals are to be avoided; and bank executives must demonstrate that they have changed significantly their cultural approach to selling products to customers if trust is to be fully restored to the sector.

29. As the lengthy, protracted process of obtaining redress for customers who were mis-sold PPI dragged on, in June 2012 the FSA published the results of a review which “found serious failings in the sale of IRHPs to small and medium-sized businesses”.⁵² Specifically, the FSA's concerns included:

48 FOS, *Ombudsman News*, Issue 91, December 2010 / January 2011, www.financial-ombudsman.org.uk

49 JQ 87

50 J Ev 240

51 JQ 701

52 FSA, *Interest rate hedging products, Information about our work and findings*, August 2012, www.fca.org.uk

(i) inappropriate sales of more complex varieties of interest rate hedging products (such as structured collars) and (ii) a number of poor sales practices used in selling other interest rate hedging products.⁵³

Abhishek Sachdev explained how some small businesses were sold hedging products that they did not understand. He described businesses being subject to penalty charges “of anything up to 20 per cent to 40 per cent of the loan amount” which were “not something they knew about at the outset”.⁵⁴ In a pilot study by the FSA, 90 per cent of sales to “unsophisticated” customers were found to be deficient.⁵⁵ The FSA reached an agreement with several banks that all sales of IRHPs since December 2001 should be reviewed and in some cases redress provided.⁵⁶

30. The loss of faith in the banking system that followed mis-selling scandals can only have been compounded by the fact that almost no individuals have been held to account for them, and the fact that, even before this Commission, old arguments were rehearsed, suggesting that some bankers have neither reflected upon nor learned the lessons of the past. Tony Boorman, Deputy Chief Executive and Deputy Chief Ombudsman, FOS told us that:

I think that it is slightly disappointing that a number of the institutions that have come in to speak to you have repeated a set of arguments that they practised at length in front of a judicial review in the High Court two years ago, which were overturned very clearly at that point. [...] Such as the argument that these are new or novel rules. Such as arguments that this has all come as a surprise. Such as arguments that our position has changed, or that the world came as a surprise.⁵⁷

Those who followed our hearings may have been surprised when Eric Daniels, the former Chief Executive of Lloyds who presided over massive PPI mis-selling, confirmed to the Commission that “we thought that, with our consistent and constant dialogue with the regulators, we were on the side of the angels. We had thought we were listening and responding. I would characterise our board and management as being responsible and responsive during this period”.⁵⁸ The words of Sir Howard Davies, on the eve of his retirement from the FSA in 2003, are apt in this context:

The biggest disappointment of my time at the FSA has been the failure of firms, in particular their senior management, to learn the lessons of past mis-selling. Sadly the recent history of the British retail financial services industry is proof of the adage that those who fail to understand the mistakes of the past are condemned to repeat them.⁵⁹

53 *Ibid.*

54 AQ 99

55 FSA, *Interest Rate Hedging Products: Pilot Findings*, March 2013, www.fsa.gov.uk

56 FSA, *Interest rate hedging products, Information about our work and findings*, August 2012, www.fca.org.uk

57 Qq 702-703

58 Q 4249

59 FSA, Annual Meeting speech, Howard Davies, 17 July 2003, www.fsa.gov.uk

These words ring particularly true in the light of the allegations on 11 June 2013 about practices at one of Lloyds Banking Group's PPI complaints handling units. *The Times* reported that an undercover reporter was told that "some bank salesman had faked PPI information in agreements on loan sales", but that complaints handlers "should effectively turn a blind eye" to the risk that this had occurred when handling individual complaints.⁶⁰ It also reported that:

When asked by one trainee why we were not automatically upholding some of the more obviously valid complaints, an executive snapped back: D'you know what? You're going to get yourself all caught up if you ask 'why do you not to do it?' It is what it is.⁶¹

If substantiated, these allegations would demonstrate a woeful failure to meet the standards expected by the FCA and by this Commission.

31. A further, and sometimes pernicious, development in the PPI story is the role of Claims Management Companies (CMCs). Even those who had never heard of PPI may have been contacted by text or by phone by companies claiming that they are owed thousands of pounds, or seen advertisements on the television. It is in this way that mis-selling has often been brought to people's attention. These practices can be annoying: 75 per cent of people surveyed in research by Aviva had received an unsolicited text or email from a CMC.⁶² They can also be damaging to outcomes for customers: CMCs take a proportion of redress received, reportedly often more than 25 per cent. Natalie Ceeney placed the blame for this situation arising squarely at the feet of the banks involved, saying:

the reason the claims management industry has been able to thrive is because detriment built over so many years while banks, in the case of PPI, said, "No, there is not an issue" [and] because banks had not done a good enough job of investigating cases".⁶³

Customer understanding

32. The mis-selling of IRHP and PPI demonstrate what can happen when banks exploit information asymmetries between them and their customers. However, providing too much small print to customers, effectively drowning them with information, may be as detrimental as not providing enough information to them, as Peter Vicary-Smith illustrated through the following example:

To open an HSBC packaged account, the consumer is expected to read 165 pages of information. No one is going to do that. As long as banks [...] provide so much

60 "Fakes, fraud and forgery in bank selling scandal", *The Times* 11 June 2013

61 *Ibid.*

62 "Aviva welcomes new conduct rules for claims management companies" 9 April 2013, www.aviva.co.uk

63 Uncorrected transcript of oral evidence taken before the Treasury Committee on 30 October 2012, HC (2012-13) 701-i, Q 3

gobbledegook that the real things you need to know are hidden, we will continue to have these problems.⁶⁴

When we raised this with Antonio Simoes, HSBC's Head of UK Retail Banking, he said "we are committed to reviewing and simplifying it. We need to have clarity and have a customer perspective."⁶⁵ Christine Farnish, Chief Executive of Consumer Focus, described the approach of bombarding customers with information they might not understand as an attempt to avoid allegations that they had not provided customers with all the information they needed:

My concern with such an approach is that too often we see the banks and other financial institutions responding to regulatory initiatives that are designed to protect consumers simply by building in a lot more process and a lot more disclosure, and by giving thicker, more dense information to the consumer, so that the consumer has everything they possibly need and no one can come back to those banks and say that they have not been treating people fairly or exercised their duty of care. It makes the whole thing more complicated and more expensive.⁶⁶

33. A recent example of apparent confusion over fine print is when the Bank of Ireland invoked a clause contained in the terms of its tracker mortgages to increase the amount over Bank of England base rate it charged its customers.⁶⁷ This clause allowed the bank to increase the rate in the event that its wholesale funding costs increased. The problems in respect of customer understanding appear to be twofold: first, that customers may not have been aware of clauses in fine print, and secondly, that even if they were aware of the clauses, it is open to question whether they would have been informed about the implications of the linkage to the bank's wholesale funding costs. The practice of linking mortgage rates to a bank's wholesale funding costs has been common in the past and is not in itself problematic.⁶⁸ However, it becomes problematic where it is not clear to customers what their agreement means in practice.

Access to banking services

34. For a significant minority of the public, obtaining access to banking services at all proves challenging. People are unable to access bank accounts for a number of reasons. Bank accounts tend automatically to include an unsecured lending facility in the form of an overdraft; therefore those with poor credit histories may have difficulty opening this type of account. A product called a 'basic bank account' has been developed to provide banking services to some of these customers, but, as discussed in Chapter 5, problems have developed with the provision of these. Banks also require certain proofs of identification before individuals can open a bank account, which some may find difficult to provide.⁶⁹

64 AQ 6

65 DQ 517

66 AQ 10

67 Bank of Ireland Group, *Base rate tracker mortgage changes*, May 2013, www.bankofireland.co.uk

68 Letter from Martin Wheatley to Andrew Tyrie MP on 12 March 2013, www.parliament.uk/treascom

69 Ev 966

Specific groups may be excluded. For example, of the major UK banks currently only Barclays provides bank accounts to undischarged bankrupts.⁷⁰ Banks seem to have been engaged in a race to the bottom by actions to discourage the take-up of basic bank accounts.

35. A separate, but related problem is that some communities may also have difficulty physically accessing banks. Yvonne MacDermid, Chief Executive, Money Advice Scotland, described:

rural and island communities in Scotland, where people are not getting access to choice at all and in some cases they have to travel many, many miles to get to a bank.⁷¹

36. In an increasingly cashless society, access to a transactional bank account has become even more important. Employers and landlords often require an account for payment of wages or rent; utility companies and councils typically offer discounts for payments by direct debit; consumer goods are often available more cheaply online than in stores. Bank accounts are the overwhelmingly dominant means by which consumers gain access to electronic payment and transaction services. Tony Greenham told us that:

Retail banking, and specifically the provision of transactional banking services and of responsible affordable credit, is different from any other consumer product and should be explicitly recognised as such. It is a basic utility and the lifeblood of the economy. There is a positive impact for society as a whole if all adults are given access to these services, in all communities and areas of the country.⁷²

37. Yvonne MacDermid said that being able to access a bank account was akin to “allowing people to participate in civic society”.⁷³ Nick Waugh, Social Policy Officer at Citizens Advice, explained that inability to access a bank account may even result in a denial of employment, because without a bank account:

you are either completely unable to accept a job, because you cannot get wages, or you have to pay money to accept your wages, because you need to pay a cheque-cashing fee.⁷⁴

38. The need to access a transactional bank account will become yet more acute with the introduction of the Universal Credit scheme to replace the current system of benefits payments.

70 *Ibid.*

71 IQ 87

72 Ev 1473

73 IQ 109

74 KQ 21

Scandal after scandal

39. In addition to failings relating to retail customers, a number of further scandals have emerged relating to the conduct of investment bankers. Andrew Bailey called the coming to light of these and other scandals as “the second phase of the crisis”, adding that:

we have seen in the last 12 months is the coming together of a whole series of conduct issues. These issues did not suddenly blow up in the last 12 months, but they have come to a head.⁷⁵

Before these scandals emerged, the world of investment banking may have seemed mysterious, even glamorous. However, in recent times, shockingly poor standards and culture have been revealed.

40. In July 2012, the FSA published its Final Notice against Barclays for the manipulation of LIBOR, revealing that not only had individual traders been manipulating the rate for the bank as a whole to give the impression that it was in better health than it actually was, but manipulating the rate for personal gain as well in behaviour that the Treasury Committee called “disgraceful”.⁷⁶ This was followed by similar revelations at RBS and UBS, and a number of other banks remain under investigation.⁷⁷ While other failings in banks might be explained by references to omissions or failures of control structures, reports of LIBOR fixing revealed deliberate, conscious deception for personal gain. This may explain the public outrage at these revelations, and the fact that it was at this point that the public reputation of banks dipped so dramatically that a consensus emerged that a distinct policy response was required.

41. As troubling as the fact of the manipulation was, what captured the public imagination were the communications between traders that were published by the FSA and the US enforcement authorities. Some of the more lurid examples were:

Derivatives Trader B:	can we lower our fixings today please [Primary Submitter B]
Primary Submitter B:	make your mind up, haha, yes no probs
Derivatives Trader B:	im like a whores drawers
Primary Submitter B:	hehehe, mine should remain flat, always suits me if anything to go lower as I rcve funds
Broker B:	gotcha, thanks, and, if u cud see ur [sic] way to a small drop there might be a steak in it for ya, haha

75 Q 4551

76 Treasury Committee, Second Report of Session 2012-13, *Fixing LIBOR: some preliminary findings*, HC 481-i, para 34

77 “Global banking scandals: Who is under scrutiny?”, *BBC News*, 20 December 2012, www.bbc.co.uk/news

Primary Submitter B: noted ;-)⁷⁸

Trader G: “Dude. I owe you big time! Come over one day after work and I’m opening a bottle of Bollinger”.⁷⁹

Euro Trader-Submitter 1: u need low 3s and/or 6s? we need low 6s ... boys, we send the fixings in about 1hr, so let us know pls

Euro Trader 1: low 6s high 12s please

Euro Trader-Submitter 1: Noted

Rates Manager A: JUST BE CAREFUL DUDE

Euro Trader-Submitter 1: yeah [Sterling Trader-Submitter 1] gave me ur call update i agree we shouldnt ve been talking about putting fixings for our positions on public chat just wanted to get some transparency though otherwise we end up with the same talks afterwards why we fixed it low or high, from u boys in ldn⁸⁰

These messages paint a picture of casual corruption set against a luxurious lifestyle. As Anthony Salz noted in his review of Barclays’ culture, these communications “seemed to confirm a pervasive, much-caricatured, unethical, greedy and selfish behaviour on the trading floors of investment banks”.⁸¹

42. In the months that followed, further scandals emerged. In 2012 it emerged that HSBC had been involved in the laundering of many hundreds of millions of US Dollars between 2002 and 2009. The laundered money entered the US financial system via a Mexican affiliate (HBMX), which had widespread correspondent accounts with the US affiliate of HSBC (HBUS). Due to HSBC Group’s weak risk-assessment procedure and inadequate compliance, serious Anti-Money Laundering (AML) deficiencies at HBMX went unremedied and huge amounts of laundered money was allowed to enter the US financial system.⁸²

43. The US Department of Justice decided, on December 11, 2012, to fine HSBC a record \$1.9bn as part of a five-year Deferred Prosecution Agreement (DPA) in respect of this and other very serious regulatory failings, including questions of sanctions-busting and

78 RBS, FSA Final Notice, 6 February, para 62

79 Barclays, FSA Final Notice, 27 June 2012, para 83

80 UBS, CFTC Order, 19 December 2012, p 40

81 Salz review: *An independent Review of Barclays’ Business Practices*, April 2013, para 3.21

82 US Senate, *US vulnerabilities to money laundering, drugs and terrorist financing: HSBC case history*, 17 July 2012, p 10

financing terrorism. There was also a Senate Permanent Sub-committee investigation and detailed report into these matters. Part of that contains a devastating analysis of the Mexican drug money laundering. Amongst others, the Subcommittee made the following finding of fact:

HBUS [HSBC Bank US] operated its correspondent accounts for foreign financial institutions with longstanding, severe AML [anti-money laundering] deficiencies, including a dysfunctional AML monitoring system for account and wire transfer activity, an unacceptable backlog of 17,000 unreviewed alerts, insufficient staffing, inappropriate country and client risk assessments, and late or missing Suspicious Activity Reports, exposing the United States to money laundering, drug trafficking, and terrorist financing risks.⁸³

44. Douglas Flint agreed that the Report of the Subcommittee was “a shocking document”, and “a very sobering read”.⁸⁴ In perhaps something of an understatement, he agreed that a lesson to be learned from this incident was that “standards that we believed were being applied globally that were set from the centre were not being applied as they should have been”.⁸⁵ He told us that the industry had “lost the right to self-determination”.⁸⁶ The failure to mitigate the risks posed by the relationship with HBMX is of particular concern in the light of the fact that these risks were known. In January 2004, two years after granting correspondent accounts to HBMX, the HSBC Board of Directors met in Mexico and concluded that HBMX would need “another two years to fully reach Group standards” in terms of its anti-money laundering controls. The Subcommittee Report concluded that “overwhelming” amounts of government information were available to HSBC regarding the specific high risk of money laundering in Mexican banks. This information was “inexplicably excluded” from the HSBC risk-assessment matrix every year from 2002 to 2012 and from 2002 to 2009 HBUS gave Mexico its lowest risk rating for AML purposes.⁸⁷ The failures also appeared to take place within a culture that incentivised risk-taking: an HSBC employee in evidence to the Subcommittee said that he experienced “an incentive compensation scheme which rewarded new accounts and growth, not quality control”.⁸⁸

45. The revelations about HSBC were followed in August 2012 by accusations by the New York State Department of Financial Services that Standard Chartered “schemed with the Government of Iran and hid from regulators roughly 60,000 secret transactions, involving at least \$250 billion, and reaping SCB hundreds of millions of dollars in fees”.⁸⁹ Standard Chartered issued a statement in March 2013 saying that it “unequivocally acknowledges and accepts responsibility, on behalf of the Bank and its employees, for past knowing and willful [sic] criminal conduct in violating US economic sanctions laws and regulations, and

83 *Ibid.*

84 Q 3782

85 Q 3774

86 Q 498

87 US Senate, *US vulnerabilities to money laundering, drugs and terrorist financing: HSBC case history*, 17 July 2012, p 43

88 Paul Thurston, Chief Executive, Retail Banking and Wealth Management HSBC Holdings plc, Written testimony for Senate Permanent Subcommittee on Investigations, 17 July 2012, p 3

89 New York State Department of Financial Services, Order Pursuant to Banking Law ss 39, 6 August 2013

related New York criminal laws”.⁹⁰ This followed earlier attempts by the bank itself to describe the failures as “clerical errors or mistakes”, demonstrating a lack of insight into the seriousness of what had occurred.⁹¹

46. Also in 2012 it emerged that a unit of JP Morgan, led by a banker known as the ‘London Whale’ because of the size of his trades, had been betting huge amounts of money, without adequate internal or external supervision, resulting in JP Morgan reporting a \$2 billion loss. An article in the New York Times summarised the affair:

JP Morgan’s trading losses were a bet, not a hedge, against risks in the bank’s other assets. As the bet soured, the bank ignored and then adjusted its internal risk alarms. As the losses piled up, it misled investigators and the public and withheld information from regulators.⁹²

JP Morgan’s Chief Executive, Jamie Dimon, famously described the affair as a “tempest in a teapot”.⁹³ Such a casual dismissal of devastating errors in the firm, expressed so eloquently, further gives the impression that the penny has still not dropped for some at the top of the industry.

47. In January 2013 it was reported that Andrew Tinney, Chief Operating Officer of the private investment division of Barclays, had resigned after attempting to suppress the contents of an independent “Cultural Assessment” of Barclays Wealth America. The Assessment described a “culture of fear”, a “revenue at all costs strategy”, and a business that was “out of control”.⁹⁴ The picture of the business described in that report is gravely troubling, and includes a total disregard for risk procedures and disrespectful and harmful treatment of employees. Sir David Walker agreed that the cultural inheritance exemplified by this incident was “egregiously bad”.⁹⁵

‘Masters of the universe’

48. It has been more than 25 years since Tom Wolfe used the term ‘master of the universe’, to describe a New York bond trader, but it has never been more apt as a description of bankers than as in the last decade. Bankers prioritised short term personal gain over their customers and shareholders and recklessly failed to prevent wrongdoing. It was a culture, in places, suffused with corruption. Yet bankers continued to enjoy an elevated position in society. Public perception of bankers’ remuneration, and particularly their bonuses, remain drivers of anger against banks and bankers. The Church of England’s Mission and Public Affairs Council explained that:

90 “Statement - US Department of Justice and the New York County District Attorney’s Office agreement”, Standard Chartered statement, 21 March 2013, www.standardchartered.com.hk

91 *Ibid.*

92 “After the ‘London Whale’”, *New York Times*, 21 March 2013, www.nytimes.com

93 See, for example, US Senate, *JP Morgan Chase Whale Trades: A case history of derivatives risks and abuses*, 15 March 2013, p 1

94 “Exposed: The regime of fear inside Barclays”, *Daily Mail*, 20 January 2013, www.dailymail.co.uk

95 Q 3521

the widely reported bonus culture, and the headline salaries, bonuses and remuneration packages of very senior bankers—packages that have not been visibly affected by the financial crisis which has brought austerity to the doorstep of most families—has gravely harmed the public perception of banking.⁹⁶

49. Lloyds Banking Group cited pay as “a key driver of customer dissatisfaction”.⁹⁷ The pay levels that the public read about involved sums that many only dream of. In 2009 it was reported that Barclays’ highest paid employee was earning £40 million per year.⁹⁸ Alison Carnwath, former Chairman of Barclays Board Remuneration Committee, told us that “pay in some instances reached obscene levels”.⁹⁹ It was reported in March 2013 that Andrea Orcel, Chief Executive Officer of the Investment Bank, UBS, who gave evidence to this Commission following revelations about LIBOR manipulation at UBS, received a package of \$26.2 million upon his appointment.¹⁰⁰ Sir Philip Hampton, Chairman of RBS, a predominantly taxpayer-owned bank, showed an extraordinary lack of judgement when he described the pay of Stephen Hester as “modest”, a phrase that was widely reported in the media. Even in its full context, Sir Philip’s comments show a failure to understand bankers’ pay in the context of the rest of society: “Now, these are still very large amounts of money, clearly, by most standards, but relative to other people doing these jobs his pay has been modest, relatively.”¹⁰¹ Stephen Hester earns a salary of £1.1 million and was set to receive a bonus of £780,000 only a month after Sir Philip made his comments.¹⁰² We alluded earlier in this chapter to the fact that anger about remuneration is exacerbated in the minds of the public by the fact that huge amounts of taxpayers’ money have been used to support the banking system while many of those who caused the failures of the past few years have emerged not only unscathed, but richly rewarded.¹⁰³ The public is also justifiably angry that, while they have injected billions of pounds into the banks, senior executives continue to take out substantial amounts of money in pay and bonuses.

50. The level of access to and influence over politicians that senior bankers had is well documented. Sir Mervyn King said that regulators prior to the financial crisis “knew that if they were tough on a bank, the Chief Executive would go straight to No 10 or No 11 and say: ‘This was an attack on the UK’s most successful industry’.”¹⁰⁴ Unite the Union argued that “banks exert significant influence over the country’s elite networks”.¹⁰⁵ Bankers’ status was also reinforced by their apparent position as beneficiaries of the honours system, often for no more than doing their jobs, and sometimes for ‘services’ that turned out to be disservices.

96 Ev 959

97 Ev 1224

98 “Barclays’ £40m-a-year man, to quit bank”, *The Guardian*, 19 July 2009, www.guardian.co.uk

99 Q 3258

100 “Orcel awarded \$26.2m to join UBS”, *The Financial Times*, 14 March 2013, www.ft.com

101 Q 4125

102 See, for example, “LIBOR scandal: RSB boss Stephen Hester “should get his bonus””, *BBC*, 11 February 2013, www.bbc.co.uk

103 See Para 12.

104 Q 4527

105 Ev 1397

Conclusion

51. An assessment of what has happened to cause concern about standards and culture in banking needs to consider the public experience. The public are customers of the banks. The public as taxpayers have bailed out the banks. The public have the sense that advantage has been taken of them, that bankers have received huge rewards, that some of those rewards have not been properly earned, and in some cases have been obtained through dishonesty, and that these huge rewards are excessive, bearing little or no relationship to the value of the work done. The public are angry that senior executives have managed to evade responsibility. They want those at the highest levels of the banks held accountable for the mis-selling and poor practice. The stain of many scandals has obscured much of the good work that banks have done, and continue to do, and the honesty and decency of the vast majority of bank employees. However, the weakness in standards and culture that has contributed to the loss of public trust in banks has not been confined to isolated parts of a few sub-standard banks. It has been more pervasive. Trust in banking can only be restored when it has been earned, and it will only have been earned when the deficiencies in banking standards and culture, and the underlying causes of those deficiencies, have been addressed.

3 The underlying causes

Introduction

52. The loss of public trust in banking charted in the last chapter is not the result of the action of a few rogue individuals or the odd dysfunctional bank. It is a collapse of trust on an industrial scale. That prudential and conduct failures have occurred simultaneously across banking is not a coincidence: it is the result of common deficiencies of standards and culture. As Sir Alan Budd told the Commission, conduct failings are “symptoms of the same sort of forces which also produced the [financial] crisis”.¹⁰⁶

53. This chapter examines those underlying causes. They stretch much further than the banks themselves: to poorly functioning and uncompetitive markets, to counter-productive instincts in regulators, to a political culture which reinforced those instincts and to a toothless sanctions regime that has failed to hold to account those who presided over recklessness or wrongdoing.

54. The underlying causes of standards failings are also heavily interlinked. For example, a giant bank that reaps significant financial benefits from the implicit taxpayer guarantee is likely to pursue rapid, leveraged growth and adopt a complex, federal structure, combining highly risky investment banking with essential retail services and deposits. Such organisations offer ample opportunities for those in positions of responsibility to evade accountability for wrongdoing, game the regulatory rule book and convince politicians of their vital importance to the wider good. These combined factors are then used to justify sparing the bank from the rigours of market discipline at the expense of consumers and, all too often when bank failure occurs, taxpayers.

This time is different

55. Crises in banking are probably as old as banking itself. A major banking panic in the Roman Empire was only resolved by a large and interest-free three-year loan from Emperor Tiberius.¹⁰⁷ Documenting this episode in 1910, William Stearns Davis noted parallels with the early twentieth century financial system that apply equally well to that of the twenty-first:

A narrative like this would have no verisimilitude unless placed in a society extending over seas and continents, with a great internal and foreign commerce, rapid means of communication, complex and vast credit transactions, an elaborate system of banking [...].¹⁰⁸

106 Ev 887

107 Tacitus, *Treason Trials, Financial Crisis, Tiberius and Astrology, Deaths of Drusus and Agrippina*, Book VI, (A.D. 32-33)

108 William Stearns Davis, *The Influence of Wealth in Imperial Rome* (MacMillan, 1910). Stearns Davis also wrote of questionable conduct by the “sage, sly, unscrupulous” *negotiatores*, or money-lenders, of ancient Rome. Emboldened by political influence, some would switch between acting as tax collectors and lenders, taking advantage of vulnerable municipal authorities by charging extortionate rates of interest. Such “extraordinary opportunities for ill-gained and easily gained wealth”, he claimed, resulted in a society where the ruling classes gauged everything in terms of money, “a cult of Mammon which has no counterpart in history”.

56. Market abuse by opportunistic speculators has been a feature of financial markets for many centuries. Edward Chancellor charted insider trading and illegal short selling of East India stock back to the early seventeenth century.¹⁰⁹ Emiliios Avgouleas argued that the history of market abuse can be explained by misaligned incentives, and that “swindlers are rational utility maximisers, especially where such swindlers are financial market professionals”. Individuals, he contends, commit financial misconduct because they calculate that the benefits to them outweigh the costs.¹¹⁰ Financial booms tend to increase the upsides of misconduct. Michael Bordo referred to a “state of euphoria where investors have difficulty distinguishing sound from unsound prospects and where fraud can be rampant”.¹¹¹

57. History is littered with financial market bubbles and their subsequent explosions. In his analysis of the 1929 crash, J.K. Galbraith wrote:

For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and serves the same purpose as [the regulator] and is, on the record, more effective.¹¹²

However, banking history is also replete with examples of failure to learn the lessons of crises. Reinhart and Rogoff argued that “no matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience”.¹¹³ Forrest Capie attributed these repeated failings to “the recurring belief that we have finally cracked it”.¹¹⁴

58. The “irrational exuberance” of the build-up to the financial crisis reads as a lesson in failing to learn the lessons of history. In part this is attributable to the interval between major financial crises. As Christine Downton told us, “financial crises don’t often happen immediately one after the other: there tends to be a lag while those people who learnt lessons move out of the industry”.¹¹⁵ Philip Augar wrote:

The banks had been so successful for so long they believed they were infallible. [...] Financial services practitioners, non-executive directors who sat on their boards and regulators all forgot that liquidity is what keeps markets going. They were blinded by their own genius.¹¹⁶

59. The “Quiet Period” from 1934 culminated in a period of unusual macroeconomic stability in much of the developed world from the mid-1980s to 2007, characterised by Ben

109 Edward Chancellor, *Devil Take the Hindmost: a History of Financial Speculation* (Plume, 1999), p 13

110 Emiliios Avgouleas, *The Mechanics and Regulation of Market Abuse* (OUP, 2005)

111 Michael D. Bordo, *The Crisis of 2007 :The Same Old Story, Only the Players Have Changed*, remarks prepared for the Federal Reserve Bank of Chicago and International Monetary Fund conference; Globalisation and Systemic Risk, 28 September 2007

112 J.K. Galbraith, *The Great Crash 1929* (Penguin, 2009, first published 1955)

113 Carmen M. Reinhart and Kenneth Rogoff, *This time is different: eight centuries of financial folly* (Princeton University Press, 2009)

114 Ev 1552

115 EQ 126

116 Philip Augar, *Reckless: the Rise and Fall of the City, 1997-2008* (Vantage, 2010), p 228

Bernanke as the “Great Moderation”.¹¹⁷ Gary Gorton has referred to what he saw as “some implicit view economists had that crises were a thing of the past” :

[...] there were no longer financial crises or banking panics. The Great Moderation, however, includes a very short period of history. From a longer historical perspective, banking panics are the norm.¹¹⁸

In our First Report we referred to the eminent authorities, including the Bank of England and the IMF, who referred in 2006 to the comforting evidence that the financial system was more resilient than in the past and less vulnerable to shocks.¹¹⁹ As Lord Turner said to us:

The classic problem for human institutions and for the design of our regulatory structures and our policy is how do we design against [delusion] in 25 years’ time, when [...] we have another: ‘This time it’s different. This time we’re cleverer than the previous generation.’ That is the institutional challenge, and we have got to try and embed the intellectual challenge, the counter point of view [...].¹²⁰

60. One factor helping to explain the false confidence of the 2007-08 pre-crisis period was an emphasis on quantitative analysis. This is not new, either. In 1976, Deirdre McCloskey warned that “forty years of investment in mathematising economics and of disinvestment in historicising economics has made it less acceptable among economists to admit ignorance of mathematics than to admit ignorance of history”.¹²¹ Mathematical justifications for claiming the market had been tamed were nothing new. Reinhart and Rogoff cited a 1929 newspaper advertisement in the run-up to that year’s financial crash, which suggested that, owing to improvements in statistics, events such as the Mississippi bubble of 1720 had become “but a wretched memory”:

Today, you need not guess.

History sometimes repeats itself — but not invariably. In 1719 there was practically no way of finding out the facts about the Mississippi venture. How different the position of the investor in 1929!

Today, it is inexcusable to buy a “bubble” — inexcusable because unnecessary. For now every investor — whether his capital consists of a few thousand or mounts into the millions — has at his disposal facilities for obtaining the facts. Facts which — as far as is humanly possible — eliminate the hazards of speculation and substitute in their place sound principles of investment.¹²²

117 “The Great Moderation”, speech by Ben Bernanke to the Federal Reserve, 20 February 2004

118 Gary B. Gorton, *Misunderstanding Financial Crises: Why We Don't See Them Coming* (OUP, 2012), p4

119 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, HL Paper 98 and HC 848 (hereafter cited as First Report), para 75

120 Q 1011

121 Deirdre (Donald) N. McCloskey, *Does the Past Have Useful Economics?* *American Economic Association Journal of Economic Literature*, Vol. 14, No. 2 (June 1976), pp 434–461

122 Carmen M. Reinhart and Kenneth Rogoff, *This time is different: eight centuries of financial folly* (Princeton University Press, 2009), p16

61. The years leading up to the 2007-08 financial crisis were, to an unprecedented degree, characterised by growing faith in the complex modeling and securitisation of risk.¹²³ Scott Paterson described how this reinforced confidence that “this time was different”:

the math wizards [...] had helped tame the market’s volatility. Out of the chaos they had created an order through their ever-increasing knowledge of the Truth.

The United States Financial Crisis Inquiry Commission found that “increasing dependence on mathematics let the quants create more complex products and let their managers say, and maybe even believe, that they could better manage those products’ risk”.¹²⁴ Paul Volcker emphasised that regulators were taken in by the wizardry, stating that the roots of the financial crisis were “all tied up in the hubris of financial engineers, but the greater hubris let markets take care of themselves”.¹²⁵

62. Another factor explaining the reduced confidence until five years ago was the difficulties of swimming against the tide. John Plender wrote that, because it is “impossible to forecast precisely when any bubble will burst”, the credibility of those drawing attention to risk is “easily undermined by accusing them of crying wolf”.¹²⁶ Raghuram Rajan argued that it was in a wide range of interests to allow the myth that “this time was different” to propagate:

The problem was not that no one warned about the dangers; it was that those who benefited from an overheated economy – which included a lot of people – had little incentive to listen.¹²⁷

Box 3 shows how a common interest in rising property prices can feature in the development of financial crises. Caprio, Demirgüç-Kunt and Kane found that “crises are caused by perverse incentives that make it worthwhile for politicians, regulators and the private sector to ignore mounting danger signals until it is too late to avoid a widespread meltdown”.¹²⁸

Box 3: Banking crises and property booms

Several witnesses drew attention to property booms as a recurring characteristic of banking crises. Charles Goodhart said that a common feature of UK, US and European banking crises had been “property finance, especially bank lending for commercial property, but also mortgage lending for residential property”.¹²⁹ Andy Haldane concurred that “property all too often is the common denominator of getting things wrong”.¹³⁰ Lord Turner told us that many banking crises have “extraordinarily common features”, of which “too much

123 See, for example, United States Financial Crisis Inquiry Commission, Final Report, January 2011, Chapter 3

124 *Ibid.* p 44

125 *Ibid.* p 45

126 “A history of hubris and flawed hypotheses”, *The Financial Times*, 13 January 2013

127 Raghuram G. Rajan, *Fault Lines*, (Princeton University Press, 2010), p 1

128 Gerard Caprio, Jr., Asli Demirgüç-Kunt and Edward J. Kane, *The 2007 Meltdown in Structured Securitisation*, World Bank Policy Research Paper 4756, October 2008

129 Ev 1537

130 Q 626

lending to commercial real estate [...] is one of the most common”.¹³¹ RBS submitted that “the great majority of financial crises in history have been associated to a considerable extent with housing and real estate lending”.¹³² Charles Calomiris wrote that “the four countries that suffered the most severe bank failure episodes of the pre-World War I era – Argentina, Australia, Norway, and Italy – had two things in common: [...] real estate boom and busts [...] and [...] unusually large government subsidies for real estate risk taking”.¹³³

Calomiris argued that, in the US in the years leading to the financial crisis, “numerous housing policies promoted subprime risk taking by financial institutions by subsidising the inexpensive use of leveraged finance in housing”. The worst of these, he contended, was requiring government-sponsored enterprises Fannie Mae and Freddie Mac to “commit growing resources to risky subprime loans” in order to “maintain lucrative implicit (now explicit) government guarantees on their debts”. He argued that these measures, made ostensibly in the name of affordable housing, were “arguably the single most destructive influence leading up to the crisis”.¹³⁴ In its recent Report on the 2013 Budget, the Treasury Committee drew attention to concern regarding the parallels between the UK Government’s new ‘Help to Buy’ mortgage guarantee policy and the precursors of the Fannie Mae and Freddie Mac schemes in the US.¹³⁵ Patrick Jenkins, banking editor of *The Financial Times*, wrote that it is “as though the Chancellor has learnt no lessons from the financial crisis itself”.¹³⁶

63. Robert Pringle told us that, for all the failures of banking regulators, “the lesson of history seems to be that autonomy leads to reckless irresponsibility if it is not constrained by a moral code and credible external sanctions”.¹³⁷ An executive of Continental Illinois National Bank, which collapsed in 1984, said in 1980 that they had wanted to “demonstrate that a Midwestern country bank can become the most magnificent force in the banking world”.¹³⁸ In pursuit of this ambition, Continental Illinois enacted an “aggressive assault” on domestic and international banking markets.¹³⁹

64. The story of Continental Illinois has echoes in the collapse of HBOS. In our Fourth Report, we described how senior HBOS management, emboldened by misplaced confidence in their own abilities, attempted to take a short-cut to becoming a major player in banking by adopting a wildly ambitious growth strategy.¹⁴⁰ A major plank of this growth

131 Q 4416

132 FR Ev 103

133 Charles Calomiris, *Banking crises and the rules of the game*, in Wood et al (eds.), *Monetary and Banking History: Essays in Honour of Forrest Capie* (Routledge 2011)

134 Charles W. Calomiris, *Banking Crises Yesterday and Today*, PEW briefing paper no.8, 2009

135 Treasury Committee, Ninth Report of Session 2012–13, *Budget 2013*, HC 1063, para 146

136 “Fannie and Freddie no model for UK housing”, *The Financial Times*, 25 March 2013

137 Ev 1293

138 1980 *Institutional Investor* article cited in the appendix to a statement by C.T. Conover, Comptroller of the Currency, to the US House of Representatives Committee on Banking, Finance and Urban Affairs, 1984

139 Appendix to a statement by C.T. Conover, Comptroller of the Currency, to the US House of Representatives Committee on Banking, Finance and Urban Affairs, 1984

140 Parliamentary Commission on Banking Standards, Fourth Report of Session 2012–13, *‘An accident waiting to happen’: The Failure of HBOS*, HL Paper 144, HC 705 (hereafter cited as Fourth Report)

strategy was the acquisition of risky assets in commercial real estate and related markets which seemingly ignored the down-side risks of such assets. In his account of the collapse of Overend, Gurney & Co in 1866, Geoffrey Elliot noted many parallels with other failures:

Money messes always start in the same way, when judgement is fuddled by greed, ambition and overweening self-confidence. Then when problems arise, there follows an obstinate refusal to admit mistakes or the imminence of disaster.¹⁴¹

65. Charles Calomiris argued that “counter-productive responses to crises”, such as the extension of deposit insurance, mortgage guarantee schemes or the erection of barriers to market entry, have acted as “visible subsidies for risk taking”.¹⁴² He used the Bank of England’s explicit removal, in 1858, of its implicit commitment to convert bills to cash in the event of a panic as “an example of effective learning”.¹⁴³ The policy was tested in 1866 with the collapse of Overend, Gurney & Co. The Bank of England declined to bail the bank out, a choice which Calomiris argued “credibly established the end of moral hazard” in such circumstances.¹⁴⁴ He concluded that, though banking crises have a long history, they are “not a historical constant” and effective policy can reduce the likelihood of them occurring.¹⁴⁵

66. 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.

67. A commission on banking standards cannot address the causes of the financial cycle which is, in any case, extremely unlikely to be eradicable. Nor should the recommendations of a UK body be expected to correct, or attempt to correct, all that is wrong in a global industry. However, that does not mean that nothing should be done. A great deal can and should be done to reduce the risk of future crises and to raise standards. There is currently a widespread appetite for measures to constrain the misconduct, complacency and recklessness that characterised the last boom and its aftermath. However, measures that are implemented while memories are fresh will be at risk of being weakened once the economic outlook improves, memories fade, and new, innovative and lucrative approaches to global finance emerge.

141 Geoffrey Elliott, *The Mystery of Overend & Gurney* (Methuen, 2006), p 10

142 Charles Calomiris, *Banking Crises and the Rules of the Game*, NBER Working Paper No. 15403, October 2009

143 Charles W. Calomiris, *Banking Crises Yesterday and Today*, PEW briefing paper no.8, 2009

144 Charles Calomiris, *Banking Crises and the Rules of the Game*, NBER Working Paper No. 15403, October 2009

145 *Ibid.*

Incentives to become unmanageable

Too big to fail

68. In our First Report we considered some of the reasons why it is difficult to allow banks to be put into insolvency in the same way as most other companies. In summary:

- **Banks provide essential services** such as current accounts, overdrafts and the payment system in general on which the rest of the economy relies. Any interruption in these services, no matter how brief, would risk causing widespread damage.
- **Insolvency destroys value.** Unlike other corporate insolvencies, when the operating business can often be maintained or sold to maximise value, in the case of a bank, all that can often be done is to liquidate the assets. Combined with the fact that banks are highly leveraged, this can magnify creditor losses, as the realisable value of assets is often very different from their carrying value.
- **Disorderly failure can cause contagion** because banks in general are reliant on the confidence of depositors and other creditors to keep operating. Allowing one bank to fail in a disorderly way could spread panic among creditors of other similar institutions and cause a wider financial crisis.¹⁴⁶

69. The challenges of letting a bank fail become more significant the bigger a bank is and the bigger the proportion of the banking system it accounts for. These challenges are particularly significant in the UK, as a consequence of its large and concentrated banking sector.¹⁴⁷ In written evidence to the Treasury Committee, the incoming Governor of the Bank of England, Mark Carney, wrote:

It is clear that concentration makes instability more costly. In concentrated systems, individual banks are more likely to be systemic and/or too big to resolve safely.¹⁴⁸

70. In the years leading up to the financial crisis, a banking system populated by large banks, with no mechanism for allowing them to fail in an orderly way, meant that it was rational for creditors of such banks to believe that they enjoyed what is often referred to as an “implicit guarantee” from the Government. If any large bank did run into trouble, the Government would be expected to step in to keep it running, which would mean continuing to meet any repayment obligations to creditors. The fact that no bank bondholders lost money (the only sector where this was true) only reinforced this belief. Douglas Flint noted how this situation lowered the cost of a bank’s borrowing and increased its appetite to take risks:

the implicit guarantee certainly encouraged those who funded banks on the wholesale side to believe that they were taking less risk than the unsecured nature of their lending represented, and because they were prepared to lend to a greater extent

¹⁴⁶ First Report, para 17

¹⁴⁷ Q 4596

¹⁴⁸ Treasury Committee, Eighth Report of Session 2012-13, *Appointment of Dr Mark Carney as Governor of the Bank of England*, HC 944, Ev 50

and on finer terms than they might otherwise done, that fund of cheaper money gave a pool of resource to bankers to make money from [...] [T]he leverage of the balance sheets seemed to grow without constraint.¹⁴⁹

71. The value of this implicit guarantee has been estimated at considerably in excess of £10 billion per annum by the ICB,¹⁵⁰ and at over £50 billion by Andy Haldane.¹⁵¹ Erkki Liikanen noted how the implicit guarantee allowed banks “to grow very fast, and still the markets thought that you should lend to them cheaply because there was no risk”.¹⁵² Sir Mervyn King recounted how, long before the financial crisis, many banks wanted to follow the model of Citigroup, then the biggest bank in the world, which was “expanding, shaving a few basis points off its funding costs by getting bigger and using the ‘too big to fail’ implicit subsidy to lower its funding costs”.¹⁵³

72. The perception of a guarantee also affected the behaviour of bank customers. The Treasury Committee wrote that the guarantee “weakened or even removed any incentive for consumers to monitor for themselves the financial institutions with which they deposit their money”.¹⁵⁴ This was even the case for larger organisations who should have had the capacity to make more sophisticated judgements about where they were depositing funds. The Communities and Local Government Committee warned of the “moral hazard inherent in an unconditional, open-ended guarantee of local authorities’ investments”.¹⁵⁵ When the Icelandic banks collapsed in 2008, UK local authorities together held £954m of deposits with them. In its analysis of this episode, the Audit Commission noted that some English local authorities “continued to invest despite clear warning signs” of bank failure.¹⁵⁶

73. Sir Mervyn King attributed a wide range of problems in banking to the implicit guarantee:

In my view, many of the failures of the system [...] stem from the very simple point of having a system that relied, in many ways quite explicitly in the minds of those working in it, on an implicit taxpayer subsidy.¹⁵⁷

As Professor Forrest Capie put it in evidence to the Commission:

What sort of policy response could be developed that might improve standards? I believe that starting with a clean slate and making it clear that failure is a distinct possibility – it is everywhere else – and will be tolerated and dealt with. There will be no rescues. There will be a lender of last resort to take care of the payments system

149 Q 453

150 Treasury Committee, Nineteenth Report of Session 2010-12, *Independent Commission on Banking*, HC 1069, para 22

151 Bank of England, The \$100 billion question speech, Andy Haldane, 30 March 2010

152 Q 128

153 Q 4554

154 Treasury Committee, Ninth Report of Session 2009-10, *Too important to fail—too important to ignore*, HC 261-i, para 22

155 Communities and Local Government Committee, Seventh Report of Session 2008-09, *Local authority investments*, HC 164-i, para 152

156 Audit Commission, *Risk and return English local authorities and the Icelandic banks*, March 2009, p 28

157 Q 4595

but that is it. Banks within the payments system can still fail. The lender of last resort is simply there to provide the liquidity needs of the market as a whole in times of stress. Regulation could then be extremely simple. Transparency could be encouraged but not legislated for. An appropriate resolution regime would help convince the market that a failure would not lead to a major disturbance. Behaviour would surely then change and if that is read as improved standards there could be little objection.¹⁵⁸

The link between the implicit guarantee and failures in corporate governance, remuneration, competition and regulation are considered later in this chapter and throughout the Report. The Commission's First Report set out how despite numerous existing and planned reforms aimed at reducing the implicit guarantee, their effectiveness in relation to the largest banks remains in doubt.¹⁵⁹ This is considered further in Chapter 4.

74. Large banks still benefit from a significant implicit taxpayer guarantee as a result of their status of being too big to fail and too complex to resolve. The guarantee affords banks access to cheaper credit than would otherwise be available and creates incentives for them to take excessive risks. The guarantee also distorts competition and raises barriers to entry. Success does not depend simply on being prudently run or on serving customers effectively, but on the implicit guarantee. The taxpayer guarantee has a wide range of harmful effects and underpins many of the failings that we identify in ensuing sections.

Too big and too complex to manage

75. The cheaper funding costs for large banks which arise from the implicit guarantee are one reason that banks have been able and incentivised to grow. The Chancellor referred to "economies of scale" in banking as another explanation for why we have large banks.¹⁶⁰ A simple example of this is the high fixed costs in establishing information technology infrastructure, which can be better absorbed by a large institution. Similarly, there may be economies of scope: large banks may be able to better diversify risk or their product offering.¹⁶¹ At the 2012 World Economic Forum, the President and CEO of Bank of America, Brian T. Moynihan, argued that global reach meant banks could serve clients better:

Our power, size, capabilities come from our clients. Why we have to have size and scale is to support people in different economies. We are big because our clients are operating around the world.¹⁶²

Bill Winters told us that scale had been an advantage because the largest banks could "satisfy the largest customers, be they sovereigns or corporations".¹⁶³ Mr Winters also

158 Ev 1513

159 First Report, para 104

160 Qq 4375-4376

161 Board of Governors of the Federal Reserve System, Brookings Institution Conference on Structuring the Financial Industry to Enhance Economic Growth and Stability speech, Governor Daniel K. Tarullo, 4 December 2012

162 "Banking Economies of Scale", *Wall Street Journal Davos Live blog*, 25 January 2012

163 Q 3701

explained that regulatory capital requirements rewarded size because of a misguided faith in the apparent diversification of risk.¹⁶⁴

76. Professor John Kay was largely dismissive of economies of scale in banking:

I do not have much sympathy for the size argument. There clearly are some economies of scale in banking, but I think they are largely exhausted at a pretty low level. To the extent that they are not exhausted they are mainly on the technological side.¹⁶⁵

He argued that banks have tended to diversify into areas they have not understood:

The greatest security you get is from diversification, but it is not from diversification into things you don't know very much about, which is the diversification we've seen a lot of in the financial sector.¹⁶⁶

Evidence by Charles Ross-Stewart, Chief Compliance Officer, EMEA, Citigroup, suggested that even technological economies may be overstated:

The complexity of the organisation does provide us with a lot of challenge—it provides everybody with a lot of challenge—and the complexity and multiplicity of our technology systems mean that sometimes getting hold of information is burdensome and time-consuming. Having an organisation such as Citi, with 250,000 employees, which has built up over a period of organic growth and acquisition, inevitably leads to quite a complex set of technologies.¹⁶⁷

77. Growth and diversification into new fields can present challenges for corporate governance. Sir John Vickers told the Commission that “the complexities of management and the lack of awareness at the top of these banks” was “a major issue”.¹⁶⁸ Some senior bank executives told us that this problem had been exacerbated by the international nature of growth. Douglas Flint said that, at HSBC, “standards that we believed were being applied globally that were set from the centre were not being applied as they should have been”.¹⁶⁹ John Hourican described a legacy of “strategic tourism” at RBS, with parts of the Group “being in too many places, doing too many things”.¹⁷⁰

78. In a speech in 2012, Andy Haldane said “there is now evidence of diseconomies which rise with bank size, consistent with big banks becoming ‘too big to manage’”.¹⁷¹ Elaborating in evidence to the Commission, he said that this was still true of apparently strongly performing major banks:

164 Q 3700

165 Q 314

166 Q 330

167 DQ 349

168 Q 2620

169 Q 3774

170 Q 4017

171 Bank of England, *On being the right size speech*, Andy Haldane, 25 October 2012

If anyone was viewed as having emerged successful from this crisis globally, it probably was J.P. Morgan; its risk management was seen as being best of breed, yet we had the London Whale incident, which suggests that a key part of that business was not being managed or overseen from a risk perspective in an effective way. The question you pose is very real. The evidence base is not encouraging about whether the biggest banks in the world can indeed manage themselves across the board.¹⁷²

79. Board Intelligence suggested that running a major bank required skills that are beyond superhuman:

Expectations on any board are arguably superhuman, but the scale and complexity of the financial service conglomerates creates an additional strain.¹⁷³

Sir Mervyn King, who as Governor of the Bank of England had a substantial range of responsibilities himself, used an example to make a similar point:

If we had had a discussion around this table before the crisis, and you had said, ‘We are getting a bit worried that it is too complex and too big. Let’s choose four people whom we really trust to put into Citibank, and they will surely know what is going on.’ Well, we might have said, ‘Let’s start with Bob Rubin, Treasury Secretary in the US, who used to run Goldman Sachs; Sandy Weill, streetwise trader who built up Citibank; Stan Fischer, one of the world’s most respected economists, former No. 2 at the IMF, now central bank governor at the Bank of Israel; and Bill Rhodes who has seen every emerging market debt crisis there has been.’

I think we would all genuinely have thought that you couldn’t get four better people to sit there and say, ‘Well, let’s see what’s going on.’ But they didn’t see what was going on. I think that is evidence that these institutions were simply too big and complex for anyone to genuinely know exactly what was going on. [...] These institutions have become absolutely enormous.¹⁷⁴

Loose federations of money-making franchises

80. Several witnesses told us that large banks were manageable, provided they were sufficiently simple. For example, Stuart Gulliver said that while a large and complex organisation would be difficult to manage, “if you’re large and reasonably straightforward I believe you can manage these things and control these things”.¹⁷⁵ Andrea Orcel, CEO of UBS Investment Bank, said that it was not only size that was important but “complexity and different types of businesses that you understand less of”.¹⁷⁶

81. Bill Winters explained how a large and complex bank might be organised:

172 Q 647

173 Ev 834

174 Q 4554

175 Q 3783

176 Q 1881

The first two are clear: you can be big and simple, and small, well-focused firms can manage complexity. So I accept the first two. Can you be big and complex? You can, but it is hard and in my opinion [...] you can be big and complex if you segment the managerial lines of your business in such a way that each piece is small, so that the complexity is managed at a small level, and if you do not allow an over-emphasis on overarching synergies across these small fiefdoms that you have created. So the very argument for being big is reduced as you slice the business up into silos that are manageable.¹⁷⁷

Mike Ashley, Head of Quality and Risk Management, KPMG Europe, made a similar point:

I think the only way you can manage a large complex organisation is by compartmentalising it and breaking it down, and frankly some organisations are better than others at achieving that, and achieving it in a way that none the less means you have visibility from top to bottom and you do not develop fiefdoms that go off and do their own thing. I don't think organisationally it is impossible to do, but it requires a great deal of effort.¹⁷⁸

82. The Centre for Research on Socio-Cultural Change drew on the theme of “fiefdoms” in writing that major banks such as Barclays and HSBC “are not unitary organisations but loose federations of money making franchises”.¹⁷⁹ The Chairman of Barclays, Sir David Walker, endorsed this description of the company he inherited, stating “the whole group did not function as a whole group; it was a set of these separate business silos”.¹⁸⁰ The Salz Review of Barclays explained that this led to a “sense of cultural difference and cultural distance between the divisions” that weakened central control.¹⁸¹ Highly profitable but culturally dubious divisions such as Structured Capital Markets and Barclays Wealth America grew largely unchecked by Group governance. Stuart Gulliver described the disparate activities of different divisions of HSBC:

At the end of 2010, HSBC was doing auto insurance in Argentina, sub-prime credit cards in the United States and corporate banking in Hong Kong. There is nothing in those activities that is remotely similar. There are no economies of scale from the systems that you can achieve, and there is no common risk platform that you can achieve.¹⁸²

Attempting to explain how money laundering in its Mexican affiliate was allowed to persist, Mr Gulliver noted that HSBC was “in 80 countries”¹⁸³ and that each “country head” was allowed “to operate without any great supervision”.¹⁸⁴

177 Q 3703

178 HQ 213

179 Ev 1403

180 Q 3623

181 *Salz review: An independent Review of Barclays' Business Practices*, April 2013, para 8.32

182 Q 3796

183 Q 3784

184 Q 3778

83. Wilful over-complexity is not the reserve of the international universal bank. In our Fourth Report, we noted that “HBOS Group operated a federal model, with considerable independence given to the division. Central challenge to the divisions from senior executive management appears to have been inadequate in the case of the three divisions that ultimately caused the most significant losses.”¹⁸⁵ Co-ordination problems and a lack of board-level control amplified the ineptitude of the Group risk function, which suffered from a low status relative to operating divisions.¹⁸⁶ Control functions and status are discussed later in this chapter.

84. The Salz Review of Barclays’ Business Practices attributes the rise of federalism to the desire to expand quickly:

Barclays pursued a bold growth strategy [...] [and] arguably achieved overall much of what it set out to do. [...] The result of this growth was that Barclays became complex to manage, tending to develop silos with different values and cultures.¹⁸⁷

The Review notes that the controversial Structured Capital Markets business “was run as a free-standing operation”,¹⁸⁸ and that the investment bank “operated as a relatively independent business within Barclays”.¹⁸⁹ We discuss the growth of the structured capital markets sector within banks in greater detail in Box 4.

Box 4: Structured Capital Markets

Structured Capital Markets (SCM) divisions had a presence in many large investment banks, although SCM in Barclays gained particular notoriety through a number of press articles, suggesting that SCM generated “up to three quarters of profits at Barclays’ investment banking operation” and that Roger Jenkins, its head at the time, was “paid as much as £40m a year as a result of SCM’s successes”.

Tax structuring as a business line developed in the mid to late 1980s within investment banks and was largely client-focused. Shortly afterwards, high street banks developed their own tax structuring businesses to take advantage of their ‘tax capacity’ – availability of profits from their retail businesses which could be ‘sheltered’ from tax. By the 1990s, SCM had evolved from a service function into a product group, designing and selling highly sophisticated, complex transactions to minimise tax. By 2000, the business had developed into a world of ‘bank-to-bank’ reciprocal deals to shelter tax. Some such deals, shortly before the financial crisis, were in the region of £5bn.

Witnesses who previously worked in SCM divisions told the Commission that the sole purpose of SCM was to make money by “minimising tax liabilities of the bank or enabling another bank to minimise its tax liabilities and taking a cut”. In terms of culture, witnesses suggested to the Commission that the excessive remuneration paid to SCM units could

¹⁸⁵ Fourth Report, para 53

¹⁸⁶ *Ibid.* para 64

¹⁸⁷ Salz review: *An independent Review of Barclays’ Business Practices*, April 2013, paras 2.11-2.13

¹⁸⁸ *Ibid.* para 7.12

¹⁸⁹ *Ibid.* para 8.35

have led to internal competition between profit centres in banks and an increase in risky behaviour. Executives from Barclays later admitted to the Commission that this business model was inappropriate and Barclays announced on 12 February 2013 that it was to close its SCM unit.

85. The diffusion of Barclays' control culture was accelerated by its purchase of parts of Lehman Brothers' North American operations in September 2008.¹⁹⁰ Bill Winters, who was a senior investment banker at J.P. Morgan before and after its merger with Chase Manhattan, outlined some of the dangers of growth through merger and acquisition:

The norm in mergers is to try to accommodate the two cultures side by side for a period of time. That leads to compromise in decision making and complexity in the organisation. [...] Any incentives that the manager had to indulge in short-term risks to generate profits and perhaps earn money are exacerbated by a desire either to gain a job or to hold on to a job.¹⁹¹

Mergers, motivated by “a relentless drive to grow earnings per share”,¹⁹² have also left banks with disjointed infrastructure, “limiting the ability of banks to make informed strategic decisions”.¹⁹³

86. The incentives for banks to become and remain too big and complex are largely still in place. As well as reinforcing the distorting effects of the implicit taxpayer guarantee, this makes banks as currently constituted very difficult to manage. Incentives to pursue rapid growth have contributed to the adoption by banks of complex, federal organisational structures insulated against effective central oversight and strategic control. These incentives were reinforced as rival banks grew through acquisitions of firms whose standards and culture they scarcely understood. Many of the consequences of unchecked pre-crisis expansion and consolidation remain, as do the perverse incentives that promoted it. As a result, many banks remain too big and too complex to manage effectively.

Blinded by science

87. In his *General Theory*, John Maynard Keynes wrote:

Too large a proportion of recent ‘mathematical’ economics are [sic] mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols.¹⁹⁴

In recent years, banking has been increasingly driven by faith in complex mathematical models and quantitative techniques at the expense of judgement and focus on high-level

¹⁹⁰ *Ibid.* para 2.17

¹⁹¹ Q 3699

¹⁹² Ev 1454

¹⁹³ Ev 1138

¹⁹⁴ John Maynard Keynes, *The General Theory of Employment, Interest and Money*, (Palgrave Macmillan, 1936)

strategic risks. Models of credit, market, and operational risk drive business decisions. In the years preceding the financial crisis, mathematical models were also used increasingly to calculate regulatory capital requirements, as discussed later in this chapter.

88. The complexity of the models used by banks, and the effort expended in building them, led to misplaced confidence in their value and a failure by banks and regulators to question their output sufficiently. Dr Andrew Hilton, Director for the Study of Financial Innovation, told the Commission that banks “got too cocky” over risk.¹⁹⁵ They recruited individuals from mathematics and physics departments who had highly quantitative backgrounds and “fell on the data like a pack of dogs on a dead cow and gorged themselves on it”.¹⁹⁶ However, many of the models they produced were based on simplistic or misguided notions of risk distributions and were highly susceptible to exogenous shocks.¹⁹⁷ The steadfast adherence to complex but flawed models was exemplified by a comment made by an official at a major UK bank on the output of a “stress test” exercise used to determine the riskiness of a commercial property portfolio:

We actually got an external advisor to [assess how frequently a particular event might happen] and they came out with one in 100,000 years and we said “no,” and I think we submitted one in 10,000 years. But that was a year and a half before it happened. It doesn’t mean to say it was wrong; it was just unfortunate that the 10,000th year was so near.¹⁹⁸

89. The Basel II international capital requirements regime allowed banks granted “advanced status” by the regulator to use internal mathematical models to calculate the risk weightings of assets on their balance sheets. Andy Haldane described this as being equivalent to allowing banks to mark their own examination papers.¹⁹⁹ A fog of complexity enabled banks to con regulators about their risk exposures:

[...] unnecessary complexity is a recipe for [...] ripping off [...], in the pulling of the wool over the eyes of the regulators about how much risk is actually on the balance sheet, through complex models.²⁰⁰

As noted in the Commission’s Report on HBOS, Lord Stevenson said that staff had devoted “tens of thousands of hours” to try and secure its Basel II waiver, and Andy Hornby conceded that the process was a “huge distraction”.²⁰¹ The outputs of models did not truly reflect the risk on bank’s balance sheets and fuelled a progressive reduction in the amount of capital held by banks against their exposures.²⁰² As Stilpon Nestor, Managing Director, Nestor Advisors Ltd, wrote, models also acted to obscure emerging risks:

195 DQ 20

196 *Ibid.*

197 *Ibid.*

198 Transcript of interview with former HBOS employee in relation to enforcement case against Mr Cummings, 9 July 2010

199 EQ 155

200 EQ 171

201 Fourth Report, para 75

202 EQ 155

Boards were following detailed Basel II capital adequacy metrics but ended up missing more than one elephant in the risk room, such as rapidly increasing gross leverage and decreasing liquidity.²⁰³

The models thus provided false justifications for banks to take and maintain ultimately unsustainable positions.

90. The lure of complexity is not an historic oddity of the pre-financial crisis era. The instruments of measurement of ‘Basel III’ which we consider further in Chapter 9 mirror many of the problems of the past. Computer-based trading represents another emerging sphere of dizzying new heights of complexity (see Box 5).

Box 5: Computer-based trading and banking standards

Algorithmic trading (AT), including its subset of high-frequency trading (HFT), is part of a long term trend of technological development in markets, in which messengers on horseback were replaced by carrier pigeons, which were in turn replaced by telegraph, and so on. However, change has accelerated in recent years. In the near future, trades will routinely take less than a millionth of a second and adaptive trading algorithms will evolve independently of human input.²⁰⁴ This activity is contended by some to have limited social value.²⁰⁵

AT delivers some benefits to markets, including improved efficiency, liquidity and price discovery and reduced transaction costs.²⁰⁶ Electronic trading can be more systematically monitored than traditional markets.²⁰⁷ There are, however, some valid concerns. There is a widespread perception that AT facilitates market abuse.²⁰⁸ AT has also been associated with market instability, most notably the US “Flash Crash” of May 2010. The paucity of evidence to assess the legitimacy of these concerns points to a worrying lack of monitoring and awareness on the part of regulators.²⁰⁹

203 C Ev 130

204 Foresight, *The Future of Computer Trading in Financial Markets—An International Perspective*, 2012

205 Bank of England, The race to zero speech, Andy Haldane, 8 July 2011

206 GQ 6

207 G Ev 33

208 GQ 12

209 GQ 12, see also G Ev 29 - 31

An absence of understanding of complex technological developments is not limited to regulators. Modern banks “are essentially technology companies”,²¹⁰ but management and boards may not be equipped to offer challenge and oversight at the forefront of change.²¹¹ This threatens an “unconscious drift towards a place we don’t like”.²¹²

A more fundamental question is the role of culture in an increasingly automated world. The growing absence of human interaction and relationships in markets has already contributed to a decline in trust.²¹³ Algorithms do not have inherent standards or culture: they are, by definition, rule-based and “controls have to be evident in the design”.²¹⁴

91. Joris Luyendijk, an anthropologist and journalist, argued that “quants” tend to lack the abilities of a “skilled politician” necessary to rise up bank management echelons.²¹⁵ At the same time, managers have incentives to accept the outputs of models at face value, even if they do not understand them:

In these huge operations, where there are a lot of quants who use terms like “standard deviation” that most others do not understand, it is very tempting to tell yourself that it is all safe. Also, you know that if it blows up, it may blow up years after you have left. [...] Some interviewees describe the CEO as essentially a PR person, keeping in place the illusion that there is control.²¹⁶

92. Risk modelling is symptomatic of wider concerns regarding the ability of boards and senior management to understand the activities of the institutions they are tasked with running. Dr Hilton said:

You have a big difference in the skill set of the top and board level managers—there is a different age structure and skill set; these are people who probably still have difficulty with their mobile phone—and the people down at the very bottom, who are actually taking the decisions that these guys are ultimately responsible for.²¹⁷

93. Excessive complexity in the major banks is not restricted to organisational structure. The fuelling of the financial crisis by misguided risk models was not simply the consequence of some mathematicians getting their equations wrong. It was the result of ignorance, coupled with excessive faith in the application of mathematical precision, by senior management and by regulators. Many of the elements of this problem remain.

210 Ev 1137

211 G Ev 31

212 G Ev 41

213 GQ 12

214 Ev 1124

215 DQ 91

216 DQq 99, 109

217 DQ 71

An accountability firewall

94. The complex structure and diverse activities of many large banks obscured senior executives' understanding of what was really going on in the businesses they were supposedly running. When conduct and risk failures came to light, this ignorance allowed many leaders to profess their shock at what had been happening, duck personal accountability and instead blame systems failures or rogue individuals. Many banks had a structure of cross-cutting functions and committees which meant that key decisions and risks were not owned by single executives but were shared, undermining a sense of individual responsibility.

95. Whether deliberate or not, ignorance and collective decision-making served to create what we described in questioning witnesses as an “accountability firewall” for senior executives. As TheCityUK noted:

While senior executives are ultimately accountable for the conduct of their staff, making this accountability meaningful poses a genuine challenge in organisations as large and varied as modern financial institutions.²¹⁸

Professor Nicholas Dorn added:

Those at the theoretical apex of the organisation may know the least about what is going on – partly because they are at some distance from the everyday lives, conversations, transactions and tactics of their subordinates, and partly because they may have a vested interest in *not* knowing in advance of any misdemeanours that might in the short-to-medium term be highly profitable for the bank.²¹⁹

LIBOR manipulation

96. Three banks (Barclays, UBS and RBS) have so far been fined in relation to the manipulation of LIBOR. In all three cases, senior executives denied having being aware of any indication at the time that false LIBOR submissions were being made to benefit trading positions.²²⁰ Bob Diamond made clear that in the case of Barclays he laid the blame on the fourteen individuals directly implicated, saying “It was wrong. It was not reported up. It should have been reported to compliance and to their supervisors”,²²¹ adding “there are aspects of this that are industry-wide, but this bad behaviour, I am not blaming on anyone. I blame it on these individuals and they are being dealt with”.²²² However, the attempted manipulation of Barclays' LIBOR submissions with the intention of personal gain continued for four years. The Treasury Committee noted that such abject and extended failures of compliance were failures “for which the board is responsible” and were only

218 Ev 1366

219 Ev 986

220 Uncorrected transcript of oral evidence taken before the Treasury Committee on 4 July 2012, HC (2012–13) 481-i, Qq153, 3969

221 *Ibid.* Q158

222 *Ibid.* Q164

possible if “the management of the bank turned a blind eye to the culture of the trading floor”.²²³

97. The conduct of UBS was much more shocking even than that of Barclays. LIBOR manipulation at UBS was very widespread, revealing an appalling failure of internal communication, or even awareness by senior management.. At least 40 individuals made over 900 documented internal requests and over 1,000 external requests to falsify LIBOR, over a period of at least nine years. “At least a further 70 individuals at UBS” were indirectly implicated.²²⁴

98. Once the financial crisis hit in late 2007, UBS also started to falsify its LIBOR submissions to protect its reputation, because a bank’s LIBOR submissions can be seen as an indicator of its financial health. There were several distinct phases between August 2007 and mid-2009 where US Dollar LIBOR submissions were set to “err on the low side”, be “in the middle of the pack”, track commercial paper rates, and then go back to “middle of the pack”.²²⁵ Each phase was initiated by directives from senior managers in Group Treasury or Asset and Liability Management, and emails clearly show why traders believed they were being asked to act this way: “[A]ll senior management [...] want to show the world we are the strongest bank with loads of liquidity”.²²⁶ However, senior UBS executives denied having ever been aware of this activity and suggested that it was understandable that such decisions could have been taken without needing to be escalated.²²⁷

99. Former UBS executives accepted some accountability for LIBOR manipulation after the event. Marcel Rohner, former CEO of UBS, said “I feel accountable for what has happened in the bank under my watch”,²²⁸ while Jerker Johansson, former CEO of the UBS investment bank, told us “I accept that I had a responsibility to actively seek out information and things that concerned me”.²²⁹ In correspondence subsequent to the hearing, Dr Rohner’s lawyer rowed back from his client’s evidence. He wrote that Dr Rohner “did not accept at the hearing yesterday any element of personal fault, in fact he specifically denied that he had been negligent.”²³⁰ Huw Jenkins, former CEO of the UBS investment bank, wrote:

I, and my colleagues, made it clear that we deeply regretted both the conduct and the fact that we did not spot this issue at the time, but at all times I acted in good faith to address the risk and other issues that we considered to be the priorities at the time.

223 Treasury Committee, Second report of Session 2012-13, *Fixing LIBOR: Some preliminary findings*, HC 481, paras 34 and 38

224 UBS, FSA Final Notice, 19 December 2012

225 UBS, CFTC Order, 19 December 2012

226 *Ibid.*

227 Q 2093

228 Q 2059

229 Q 2041

230 Ev 1320

With hindsight those issues could have been better prioritised but that clearly does not constitute negligence.²³¹

100. In the case of Barclays, where manipulation of LIBOR for profit occurred on a smaller scale than UBS but senior executives were involved in decisions to “lowball” LIBOR submissions for reputational reasons, the Chief Executive Bob Diamond wrote to the Treasury Committee:

As well as accepting the authorities’ penalties and apologising, it is important that Barclays takes further action. First, we must demonstrate responsibility. That is why I, and three of my senior colleagues, volunteered to forgo any consideration for bonuses in 2012, recognising our responsibility as leaders of the organisation in which these events occurred.²³²

It was only subsequently, following intervention from the regulators and public and political pressure that the Chief Executive, Chairman and Chief Operating Officer stepped down from their posts.²³³

101. When the FSA announced its fine of RBS for LIBOR manipulation, it was announced at the same time that the head of its investment bank, John Hourican, would step down. This does not necessarily mean that RBS had clearer accountability structures in place than Barclays; it may reflect that the political realities of the fact that someone had to be seen to accept the consequences were better understood. When appearing before the Commission, RBS’s executives articulated feeling responsible for failures. John Hourican said:

I do accept responsibility for the behaviours of our staff, and therefore, I accept responsibility for the failings that were found. It is important that we don’t talk about accepting responsibility, and then not do so in our actions. That is why I resigned.²³⁴

Peter Neilson, who was head of the RBS business area in which the LIBOR manipulation took place, said “I do accept responsibility and I am accountable for those failings”, but defended his decision not to offer his resignation: “I believe that we have accomplished a great deal since attempting to right the bank in 2009. I have appreciated being able to play a part in that, and I think I have got some more to offer”.²³⁵

Payment protection insurance

102. The scandal of PPI mis-selling was described in Chapter 2. In written evidence to the Commission, Which? argued that collective responsibility for consumer issues had contributed to conduct failings in this area. In the absence of a “single, defined member of senior management” responsible for following up customer complaints or vouching for the

231 Ev 1564

232 Letter from Bob Diamond to Andrew Tyrie MP, 28 June 2012, www.newsroom.barclays.com

233 Treasury Committee, Second Report of Session 2012-13, *Fixing LIBOR: Some preliminary findings*, HC 481, paras 185–193

234 Q 3907

235 Qq 3908-3909

terms of a new product, they argued, incentives to ensure high standards were limited.²³⁶ Which? observed that “not a single individual senior banking executive has ever had enforcement action taken against them for presiding over the mis-selling of products”.²³⁷

103. With reference to PPI, Helen Weir, former Principal, Retail Distribution, Lloyds Banking Group, demonstrated a vague and collective accountability structure:

Rory Phillips: In your retail role, I think you were ultimately accountable, weren't you, for PPI sales process in the retail bank?

Helen Weir: It is correct that the retail bank operations were part of my responsibility.

Rory Phillips: That accountability was reflected, wasn't it, in the reduction by some 25 per cent of your bonus for 2010, which was announced by the group in February 2012, following the increased provisions for PPI?

Helen Weir: I believe that in that announcement, the board made it clear that what they were doing was reflecting the accountability of the executive directors of the board in those bonus reductions.²³⁸

104. The FSA explained some of the difficulties of establishing blame at senior levels in the context of conduct cases involving junior staff:

Decisions were made further down the chain of command. If the delegation was appropriate (i.e. to an appropriately qualified person with suitable resources etc) the more senior individual will not be at fault. In conduct cases (although perhaps less so in prudential matters) the decisions which are made which impact adversely on customers may sometimes be made a long way from the top of the organisation and the senior management and/or board currently have relatively little visibility of them.

It is unclear who was responsible for a decision (or series of decisions) because lines of accountability are unclear or confused, or because they pass, at some point, through people who are not approved (and are not required to be).²³⁹

Conclusion

105. 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

²³⁶ Ev 1464

²³⁷ Ev 1463

²³⁸ JQq 485-6

²³⁹ Ev 1056

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.

Paid too much for doing the wrong things

Falling bonuses, rising salaries

106. In Chapter 2, we noted that public anger with banking is fuelled by the seeming disparity between the amount bankers earn and the value they add—or harm some of them cause—for society. This section notes how remuneration in banking seems not really to have fallen since the crisis, despite the clear evidence that many bankers were not as productive as had been previously claimed. It also sets out how the distorted incentives leading to such high pay contribute to poor prudential and conduct standards. Chapter 8 considers in more detail how high pay in banking is the symptom of wider failures, and considers how remuneration frameworks could be reformed to better align incentives.

107. Much has been made of how bank bonuses have fallen in recent years. The Chancellor referred to CEBR estimates that the total City bonus pool has fallen from £11.5bn in 2006 to £1.5bn in 2013.²⁴⁰ Anthony Browne said that, since 2007, cash bonuses are down 77 per cent and the total bonus pool has more than halved.²⁴¹ Between 2010 and 2012, variable pay fell by 28 per cent at Barclays and 51 per cent at RBS.²⁴²

108. However, total remuneration in banking—including both base salaries and bonuses—has not seen the same level of reduction that these headline numbers would suggest. As the chart below shows, total remuneration across the UK's largest four banks has in fact been much more stable:²⁴³

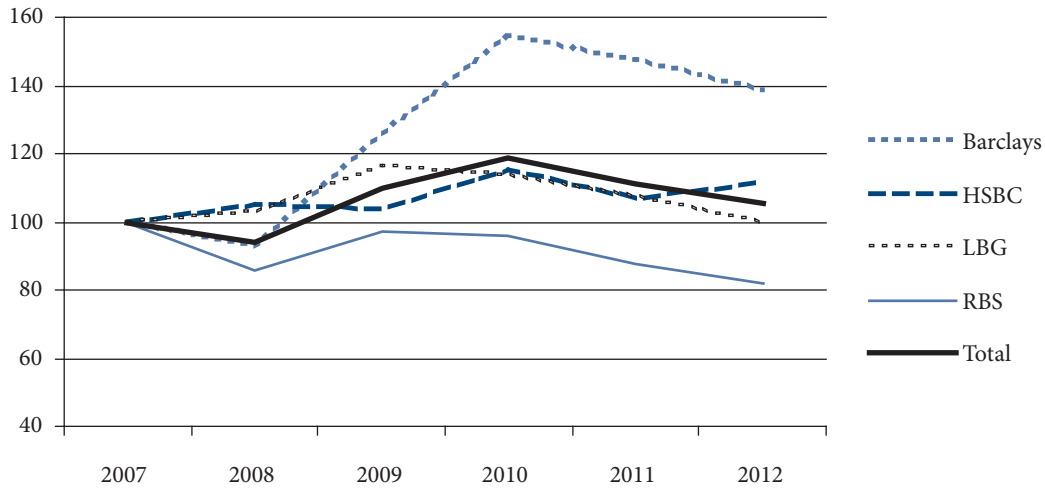
240 Q 4381

241 "Banks must show they are now very different creatures", BBA Blog, 19 April 2013, www.bba.org.uk

242 See Annex3.

243 Barclays 2007/08 figures exclude BGI as a discontinued activity. LBG figures for 2007 and 2008 represent the sum of Lloyds TSB and HBOS. We have added back one off pension credits of £910m and £250m in 2010 and 2012 respectively. RBS figures are on a pro forma or managed basis. The Barclays figures partly reflect the additional costs from the acquisition of parts of the Lehman Brothers business in September 2008. The LBG figures partly reflect the merger with HBOS in 2009.

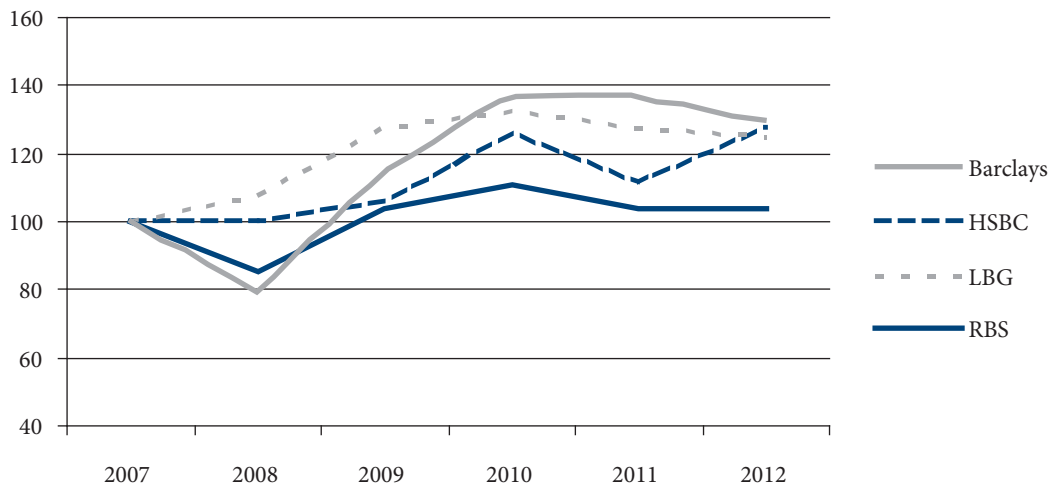
Chart 1: Aggregate employee remuneration in large UK banks (2007=100)



(Source: Company reports and accounts and staff calculations. Further detail available in Annex 3)

109. While aggregate remuneration across the sector has remained relatively stable, staff numbers have fallen, meaning that per-capita remuneration has actually increased over recent years. The chart below shows how per-capita remuneration, including both fixed and variable pay, has changed in the UK’s largest banks. It can be seen that per-capita remuneration fell sharply at RBS and Barclays in 2008 but that overall most banks’ per capita remuneration is now close to or above its pre-crisis level.

Chart 2: Per-capita remuneration in large UK banks (2007=100)



(Source: Company reports and accounts and staff calculations. Further detail available in Annex 3)

110. The discrepancy between the much-vaunted falls in bonuses and the reality of static or rising total and per-capita remuneration is in part due to a shift from variable to fixed pay. For example, at Barclays, the Salz Review found that:

fixed pay as a proportion of total compensation has changed significantly, increasing on average from 65 per cent in 2010 to 76 per cent in 2012 across the Group. This

shift has been even more pronounced in the investment bank where average fixed pay has risen from 25 per cent in 2007 to 59 per cent in 2012, and from 6 per cent in 2007 to 32 per cent in 2012 for managing directors only, reflecting both absolute increases in fixed pay and significant reductions in average bonus.²⁴⁴

111. Public anger about high pay in banking should not be dismissed as petty jealousy or ignorance of the operation of the free market. Rewards have been paid for failure. They are unjustified. Although the banks and those who speak for them are keen to present evidence that bonuses have fallen, fixed pay has risen, offsetting some of the effect of this fall. The result is that overall levels of remuneration in banking have largely been maintained. Aggregate pay levels of senior bankers have also been unjustified. Given the performance of the banks, these levels of pay have produced excessive costs. Indeed, at a time of pay restraint in the public and private sectors, they will raise significant anger amongst taxpayers who have been required to subsidise these banks. These elevated levels of remuneration are particularly unacceptable when banks are complaining of an inability to lend owing to the need to preserve capital and are also attempting to justify rises in charges for consumers.

Payment by the wrong yard sticks

112. The opportunity quickly to earn huge amounts creates strong incentives to obtain them. Sadly, such incentives have often led to behaviour which is incompatible with high standards, and which contributed to many of the failures in banking. Andy Haldane explained that the widespread use of return on equity (RoE) in determining individual rewards for bankers resulted in incentives to increase leverage and take undesirable risks:

It is deeply irresponsible to be using performance metrics that fail to take adequate account of risk. The reason why the return-on-equity metric [...] is a problem is that it can be easily gamed by risking up the system through leverage.²⁴⁵

113. PWC concurred that this “feedback loop between pay and performance reinforced a certain cycle of behaviour”.²⁴⁶ The Chartered Institute of Personnel and Development wrote that remuneration practices in banking “have not only led to rewards for failure, but have incentivised the sort of behaviours that led to the financial crisis and have damaged trust in the financial system”.²⁴⁷ Global Witness added that banks fail to use non-financial measures of performance in remuneration decisions:

the pay of bankers is almost exclusively linked to their financial performance ie how much money they make for their institution, rather than whether their behaviour is compliant with applicable rules and regulations or even in the long term interests of their customers.²⁴⁸

244 *Salz review: An independent Review of Barclays’ Business Practices*, April 2013, para 11.29

245 EQ 164

246 C Ev 151

247 Ev 935

248 Ev 1082-1083

114. Compensation in investment banking has largely been funded on a share of profits basis, without employees being required to provide capital.²⁴⁹ David Bolchover explained that this led to misaligned incentives:

It is only human instinct that if you have a huge upside reward for taking risk, you will take that risk knowing full well that the worst that can happen to you is that you lose your job in a few years, but you have several million pounds in the bank already. Clearly, there was an imbalance of risk.²⁵⁰

Martin Taylor told us that the problems of payment based on profits were exacerbated as banks were “using mark-to-market accounting to increase their profits as asset prices rose in the boom and then paying out the unrealised profits in cash”.²⁵¹ In their written evidence, the Financial Reporting Council acknowledged concern regarding “the link between volatile unrealised profits and bonuses”.²⁵² Sir Brian Pitman, the long-term chief executive of Lloyds TSB has also highlighted that the special features of the banking sector exacerbated the dangers of linking remuneration to short-term performance. He has said:

One of the great differences between banking and other activities, is that in banking you can increase the profits simply by changing the risk profile. I was chairman of [the retailer] Next at one time, and we couldn’t wake up in the morning at Next and say, what we’re going to do is greatly expand our business, what we’re going to do is increase the risk profile. But in banking, it’s perfectly possible, in the short term [...] And if you gear up the remuneration system appropriately, you can become rich quite quickly”.²⁵³

115. Professor Charles Goodhart argued that payment in shares, with the objective of aligning staff incentives with those of shareholders, provided incentives to undertake risky behaviour:

Bankers are responsive to, and largely remunerated in the same way as, shareholders. They generally have bonuses in equity form; most senior bankers have, and are expected to have a large equity shareholding in their own bank. Equities have limited liability status. The down-side is limited; the up-side is not. This convex pay-off, equivalent to a call option on the bank’s assets, makes the pursuit of risk an attractive way of enhancing one’s own welfare for a banker. To follow such incentives is natural.²⁵⁴

Andy Haldane told us that “the incentives created by paying in shares are every bit as great as the incentives created by paying in cash”.²⁵⁵ Professor Goodhart concluded that

249 C Ev 154

250 Q 3194

251 Q 2946

252 Ev 102

253 Ev 1453

254 Ev 1538

255 Q 166

incentive structures in banking were so misaligned that bankers were “surprisingly responsible” in the circumstances.²⁵⁶

116. The calculation of remuneration in investment banking and at the top of banks remains thoroughly dysfunctional. In many cases it is still linked to inappropriate financial measures, often short-term, while long-term risk is not adequately considered. Individuals have incentives to be preoccupied with short-term leveraged growth rather than sustainability and good conduct.

Incentives to mis-sell

117. The Commission received evidence on similar flaws in remuneration in retail banking. The TUC noted that, while rewards were of a very different magnitude to those in investment banking, remuneration structures in retail banking similarly promoted undesirable behaviour:

Just as performance related pay affects behaviour at the higher end of the banking pay scale, it also causes distortions at the bottom end. A sales driven culture with sales targets and performance related pay linked to indicators such as product sales incentivises retail banking staff to sell unnecessary and risky products to households and SMEs [...].²⁵⁷

Lloyds Banking Group partly conceded this link:

In the recent past the structure of variable compensation packages across the retail banking industry has been characterised by an excessive emphasis on sales targets. This may, in some cases, have had a detrimental impact on behaviour.²⁵⁸

Citizens Advice stated that bank staff had had “incentives to sell products which make a profit for the bank, rather than considering which product is best for the customer’s needs and circumstances”.²⁵⁹ Peter-Vicary Smith told us “an Alliance and Leicester salesman at one time would be earning six times as much personal commission for selling a loan with PPI as for selling a loan without PPI—lo and behold, PPI was mis-sold”.²⁶⁰

118. Stuart Davies, Regional Officer, Unite the Union, told us that a “very aggressive sales culture” still existed in banks.²⁶¹ Dominic Hook, National Officer, Unite the Union, added:

There are still banks today with notice boards on the wall that list all the individuals, with what they have sold in the past week and who is top and who is bottom. [...] It creates a lot of stress and means that the pressure on them to mis-sell or to be in

256 Ev 1538

257 Ev 1377

258 Ev 1224

259 Ev 966

260 JQ 3

261 JQ 276

circumstances where mis-selling can happen is much greater. We think that it is a cultural thing that comes right from the top of any organisation.²⁶²

Citizens Advice made the point that the use of sales incentives in the case of PPI had ultimately had “sizeable [negative] consequences for the banks themselves”.²⁶³ Paul Geddes, former chief executive of RBS UK retail said that “there was a real risk” with an incentive scheme which gave double sales points for selling a loan with PPI and gave higher points for bigger loans. Ms Weir acknowledged that Lloyds should have done more, saying that the bank “went to great lengths to try to put in the checks and balances, but I think with hindsight, it would have been better to address some of those incentives.”²⁶⁴ Gordon Pell, former Deputy Chief Executive of RBS, said that he did not sign off the RBS frontline staff incentive scheme and was not aware that there were double points for PPI sales.²⁶⁵

119. Though they have been much less generous than in investment banking, poorly constructed incentive schemes in retail banking have also hugely distorted behaviour. They are likely to have encouraged mis-selling and misconduct. Senior management set incentive schemes for front-line staff which provided high rewards for selling products and left staff who did not sell facing pressure, performance management and the risk of dismissal. It shows a disregard for their customers and front-line staff that some senior executives were not even aware of the strong incentives for mis-selling caused by their own bank’s schemes. These remuneration practices are ultimately not in the interests of banks themselves, still less of the customers they serve.

Inadequate checks and balances

An absence of collective responsibility

A decline in loyalty

120. The tendency of remuneration systems to reward short-termism and risk-taking has been mirrored in wider bank culture. Sir Alan Budd wrote that the decline of the partnership model led to a two-way decline in loyalty:

the weakness of employee loyalty was matched by the terms and practices of employment. People could lose their jobs at a moment's notice if market conditions were believed to require it. Loyalty works both ways.²⁶⁶

This process, he contended, means that individuals had increasingly worked “at banks” rather than “in banks”.²⁶⁷ Loyalty, where it was afforded, was to “hero” investment

262 JQ 292

263 Ev 966

264 Q 623

265 Qq 414-415

266 Ev 886

267 *Ibid.*

bankers,²⁶⁸ and direct line managers, rather than to the institution, as John Reynolds, a former investment banker, explained:

The internal culture within investment banks, and the investment banking arms of universal banks, is often based on patronage by individual senior bankers. This results in loyalty required to be shown to individuals rather than the organisation in order to achieve promotion (and pay).²⁶⁹

The Salz Review of Barclays showed that individual loyalty to immediate superiors rather than to the whole organisation had led to “different sub-cultures”. The report stated that staff “were likely to make their own decisions about values, based on what seemed to be important to their business unit head—or even the individual leaders to whom they reported”.²⁷⁰

121. Robert Pringle told us that declining staff loyalty to the banks at which they worked had been reinforced by the recruitment of entire teams:

The ideas of loyalty and long-term service to one's employer and its culture were discarded. Teams of specialists were bought and sold like slaves or football stars.²⁷¹

Andrea Orcel, who was recruited to UBS from Bank of America Merrill Lynch with a £17 million “golden hello”,²⁷² concurred that in taking short-cuts in recruitment, through recruiting teams or pursuing rapid expansion through pay inflation:

you don't integrate the people into your culture. To grow this business organically, which is the only way you should be growing it, takes a longer time.²⁷³

A cult of the high-earning individual has led to top traders being promoted to management positions. Joris Luyendijk, an anthropologist and journalist, argued that they were often unsuitable for such positions, suggesting that “the skills you need to be a good trader are almost opposite to the skills you need to be a good manager [...] managing or trading are just completely different things”.²⁷⁴ There needs to be a reintroduction of the difference in pay structures between those who trade or transact and are remunerated on those transactions, and those who manage traders. The total remuneration of those who manage should not directly reflect the performance of those who trade.

Front office versus back office

122. Those in control functions tended to be paid far less than those in revenue-generating positions. Richard Goulding, Group Chief Risk Officer, Standard Chartered, explained:

268 Ev 1455

269 Ev 1310

270 *Salz review: An independent Review of Barclays' Business Practices*, April 2013, para 8.21

271 Ev 1289

272 “UBS banker gets \$26m 'golden hello'”, *BBC*, 14 March 2013, www.bbc.co.uk

273 Q 1996

274 DQ 91

Clearly in areas such as market risk, you get better paid if you go into a trading or potential sales job than if you remain within the market risk function. That is not to say that jobs in the market risk control function are not well paid; they are, but they are not as well paid as the front office.²⁷⁵

In a world where, according to Sir Alan Budd, success is measured by money,²⁷⁶ this might be expected to reinforce front office primacy. Mr Goulding argued that this is not the case:

Baroness Kramer: So what would the status be of your folk down on the floor level versus the revenue generators? How would they perceive themselves in relation to the revenue generators?

Richard Goulding: I frequently receive complaints that the people in risk are actually too powerful in the organisation, which is probably the right sort of complaint to be getting.²⁷⁷

Mr Luyendijk disagreed:

Back-office people say they know when a colleague has to call a front-office person, because usually the colleague reaches a number of times for the phone before he picks it up.²⁷⁸

The remuneration gap, he argued, has resulted in a more fundamental cultural divide along lines of status:

There are these hugely different activities, but if there is one big divide, it would be between back office, middle office and front office. There is an overriding sense of identity that people have when they are in one of those three places. Some of the anecdotes are just so telling. I spoke to a gay banker who wanted to organise a networking event for gay bankers in his bank. He finally got a lot of people whom he knew and who were out to come to the thing, but then those bankers realised there would be gay bankers from the back office, middle office and front office. The front-office gay bankers said, “No, I’m not going to an event with back-office bankers.” That really tells you something about how deep these things go.²⁷⁹

123. At its worst, this cultural divide has manifested itself in a climate of bullying and fear, whereby compliance staff were unable to challenge the front office. A report into Barclays Wealth America concluded:

The current leadership team have pursued a course of “revenue at all costs”, taken a conscious decision to ignore support functions, reinforced a culture that is high risk

275 DQ 159

276 Ev 886

277 DQ155

278 DQ 78

279 DQ 76

and actively hostile to compliance, and ruled with an iron fist to remove any intervention from those who speak up in opposition.²⁸⁰

Personality types

124. Joris Luyendijk said that trading floor recruiters select “testosterone-infested alpha males” and explained that this is seen as a useful quality in a highly dynamic environment as “nice guys finish last on the trading floor”.²⁸¹ In a 2008 study of men on a City trading floor, Professor John Coates found that a combination of instinctive risk-taking and herd behaviour tended to result in irrational decisions and exaggerated market swings.²⁸² Mr Luyendijk quoted the concerns of a regulator that he was “not so much worried about a banker lying to me; I’m worried about a banker lying to himself that he oversees the risks taken”.²⁸³ The Chartered Institute of Personnel and Development told us that the banking industry had created a “somewhat self-reinforcing, monolithic working culture [...] with the same types of people recruited time and again”, reinforced by “rewarding the same behaviours and personality types based on delivery of financial performance above all”.²⁸⁴

An eroded professional ethos?

125. There was no golden age of banking standards in the UK. While a customer in the 1950s may have received a personal service from a bank manager who was a pillar of the local community, the majority of the population were unbanked, “branches closed at 3pm, bank charges were levied entirely at the manager’s discretion, and credit was confined to overdrafts and short term credit”.²⁸⁵ The banks “operated as a closed shop when it came to interest rates, wages and salaries, protected by an agreement not to poach each other’s staff”.²⁸⁶ As Sir Alan Budd wrote, “it was not obvious [...] that the careful and rather comfortable way of doing business was in the best interests of the customers”.²⁸⁷ Sir David Walker told us that the City of London of “the good old days” was “tainted by what we would now regard as clear malpractice”.²⁸⁸

126. Banking prior to the Big Bang was, however, subject to greater restraints. Rigid hierarchies and long careers rewarded loyalty and prudence. In the City of London, unspoken agreements and social norms shaped conduct. Though the prevailing culture was “incompetent, clubby and protectionist”,²⁸⁹ “the ethos was at least as important as regulations in controlling behaviour”, with the worst excesses constrained by the need to

280 Genesis Ventures report on Barclays Wealth America seen by the Commission and quoted in “Exposed: The regime of fear inside Barclays - and how the boss lied and shredded the evidence”, *The Mail on Sunday*, 20 January 2013

281 DQ 81

282 J. M. Coates and J. Herbert, “Endogenous steroids and financial risk taking on a London trading floor”, *Proceedings of the National Academy of Sciences of the United States of America*, vol. 105 no. 16, pp 6167–6172

283 DQ 99

284 Ev 935

285 Ev 1323

286 Ev 1454

287 Ev 886

288 Q 1

289 Ev 1454

maintain social standing.²⁹⁰ Anthony Sampson wrote of the City having a “tribal past” with no need for “fuss and lawyers”, but relying on a tradition of mutual trust.²⁹¹ Rewards for risk-taking were not so high as to override reputational concerns.

127. These, largely domestic, established codes of behaviour have largely been eroded. Witnesses pointed to the role of globalisation. Robert Pringle argued that international “investment banks’ business model and ethic seemed ideally suited to the emerging global financial market”, with a concomitant influence on the prevailing culture.²⁹² Virgin Money pointed to the impact of the increasingly international nature of bank staff:

With people from different geographic and cultural backgrounds, there may not be a shared intuitive response to issues as they arise. This may lead to reliance on the rules as stated—or even to the view that, if something is not specifically prohibited in the rules, it is permitted.²⁹³

The Financial Services Consumer Panel linked the decline of personal interaction on trading floors to the Big Bang:

The so-called “big bang” in wholesale market trading of banks and investment firms of the 1980s took away the physical trading floors that relied on personal contact and relationships between the parties and introduced electronic exchanges and trading platforms. [...] What was once the basic tenet of the London stock exchange “my word is my bond” is no longer given credence. As practitioners and customers no longer exchange so many words, fewer bonds can be created.²⁹⁴

Sir Alan Budd described how the emerging investment banking culture at Barclays clashed with that of the established clearing bank:

The clearing bankers regarded the investment bankers as overpaid, reckless and not loyal to the bank. The investment bankers regarded the clearing bankers (who provided the capital) as timid, unimaginative and slow.²⁹⁵

Sir Alan suggested that the approach of traditional banking was no match for the seductive fast buck of the brash interloper:

By this time another cultural shift had taken place in investment banking. As trading profits in securities and derivatives rose inexorably in buoyant markets, the power of the traders rose in their organisations at the expense of more staid corporate financiers. The individualistic, bonus-driven ethos of the trading floor permeated institutions in which the idea of fiduciary obligation to customers was ebbing away.²⁹⁶

290 Ev w 889

291 Anthony Sampson, *Anatomy of Britain*, (Hodder and Stoughton, 1962), p 348

292 Ev 1289; see also Ev 737.

293 Ev 1424

294 Ev 1036

295 Ev 886

296 “How traders trumped Quakers”, *The Financial Times*, 6 July 2012, www.ft.com

128. The increasing lack of professional identity in banking has facilitated a process whereby people with little understanding of the distinct characteristics and risks of the industry have assumed leadership positions. Prominent examples of this trend are Fred Goodwin, a chartered accountant, becoming chief executive of RBS, and James Crosby and Andy Hornby, an ex-actuary and a retail manager respectively, becoming successive chief executives of HBOS.

129. Professional standards in banking were, according to Hermes Equity Ownership Services, “never akin to those developed, imposed and enforced by the genuine professions”.²⁹⁷ The dilution of traditional codes of behaviour, combined with the specialisation demanded by the complexity of modern banking, have rendered industry bodies increasingly irrelevant. The Chartered Institute of Bankers, founded in 1879 and awarded a Royal Charter in 1987, re-formed as the *ifs* School of Finance, a commercial examining body.²⁹⁸ The Chartered Institute of Bankers in Scotland, founded in 1875 and awarded Royal Charters of incorporation in 1976 and 1991, has expanded its ambitions to the entire UK.²⁹⁹ However, it has just 4,000 chartered bankers on its books and felt unable to withdraw the membership of Fred Goodwin, who has lost both his knighthood and the opportunity for golf club membership, in the absence of formal regulatory intervention.³⁰⁰

130. It would be wrong to indulge in misplaced nostalgia about either the friendly community bank manager of bygone days or the quintessentially British culture of the City of London prior to the emergence of the universal banking model. Nevertheless, changing incentives in the sector, together with the impact of globalisation and technological change, have eroded cultural constraints upon individuals’ behaviour. Banking now encompasses a much wider range of activities, has fewer features of a professional identity and lacks a credible set of professional bodies.

Unreported misconduct

131. The erosion of professional standards in banking is such that those committing misconduct have not always felt the need to be discreet. As noted by Robert Pringle, the culture of UK banking has become one of “what you can get away with”, rather than “what is right”.³⁰¹ Barclays Wealth America pursued a course of “revenue at all costs”, driven by “a culture of dominance and fear” that was actively and openly hostile to compliance.³⁰² Retail banks have not been immune to blatant misconduct. Dominic Lindley, Principal Policy Adviser, Which?, said that some PPI products were “so toxic and so expensive, that they should not have been sold to any consumers”.³⁰³

297 Ev 1109

298 Ev 1126

299 Ev 927

300 Qq 2381-2399

301 Ev 1287

302 Genesis Ventures report on Barclays Wealth America seen by the Commission and quoted in “Exposed: The regime of fear inside Barclays - and how the boss lied and shredded the evidence”, *The Mail on Sunday*, 20 January 2013.

303 JQ 4

132. One of the most striking features of the series of banking conduct failures has been the absence of whistle-blowing. Ian Taplin noted the extraordinary fact that “there is no public record of any banking employee raising concerns or whistle-blowing” with regards to PPI.³⁰⁴ The attempted manipulation of LIBOR at Barclays, UBS and RBS was found by the FSA to have continued for a combined total of nearly 20 years, with the direct involvement of 78 individuals in nearly 1,300 documented internal requests and well over 1,000 external requests for alternations to submissions.³⁰⁵ Much of this manipulation was “deliberate, reckless and frequently blatant”.³⁰⁶ However, no one blew the whistle.

133. John Hourican, the senior RBS executive who resigned over LIBOR manipulation despite not being found personally culpable, told us that, in a healthy bank, collective responsibility would snuff out poor behaviour at source:

Having a lot of whistleblowing in a company that is not part of the normal running of the company is almost as bad as having none, because what we want to have is a culture where people hold each other to a high level of moral account in the company—that is certainly what I would like to aim for.³⁰⁷

Joris Luyendijk told us the pervading culture of banks “is very much organised around silence”.³⁰⁸ Martin Woods, a whistleblower, expanded on this, noting that those who witnessed wrongdoing “become passive observers” and were influenced by a “gang mentality” to accept the status quo.³⁰⁹ Neil Jeffares, a former investment banker, said that whistleblowers could be ostracised by their peers:

Bankers who object to unethical practices, or simply to excessive risk, will be labelled as trouble-makers or just treated as “not a team player”. Their departure from the bank may be covered under a variety of headings and protected through rigorous compromise agreements. Since it is unlikely that the practices they object to will result in criminal convictions, they are rarely in a position safely to communicate their experiences in public.³¹⁰

134. Misconduct has been propagated by this manifest failure of bankers at all levels to accept responsibility. Professor Nicholas Dorn, Erasmus School of Law, Erasmus University Rotterdam, wrote that the incentives of middle and low level employees are such that they “can passively gain from the recklessness and misdemeanours of their peers”.³¹¹ Neil Jeffares wrote that a failure to acknowledge misconduct is not necessarily tantamount to dishonesty. He argued that a “generation of bankers” has “willingly adopted” faith in the efficiency of the market “as an excuse for not considering the broader

304 Ev 1342-1343

305 Barclays, FSA Final Notice, 27 June 2012; UBS, FSA Final Notice, 19 December 2012; RBS, FSA Final Notice, 6 February 2013

306 UBS, FSA Final Notice, 19 December 2012; RBS, FSA Final Notice, 6 February 2013

307 Q 4026

308 DQ 74

309 Ev 1631

310 Ev 1169

311 Ev 986

implications of their conduct” and suggested that many “may genuinely believe that they are doing nothing wrong if neither statute nor regulation prohibits a profitable practice”.³¹²

135. 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.

Out of control

Maginot lines of defence

136. The major banks typically told the Commission that they operate a “three lines of defence” control framework.³¹³ The Chartered Institute of Internal Auditors explained that the first line “is line managers and staff who own the risks that they take every day”, the second is “specialist risk management, control and compliance functions” and the third is internal audit.³¹⁴ The following chart, reproduced from a paper by the Institute of Internal Auditors, illustrates the roles of each line of defence:³¹⁵

First Line of Defence	Second Line of Defence	Third line of Defence
Risk Owners / Managers	Risk Control and Compliance	Risk Assurance
- operating management	- limited independence - reports primarily to management	- internal audit - greater independence - reports to governing body

137. Through this chapter, we have reported evidence that the major banks are so large and complex as to be unmanageable, are beset by mis-aligned incentives that promote risky behaviour and are subject to a dearth of accountability. The highest revenue earners on the front line attain untouchable status, as a derivatives trader told the *Guardian* banking blog:

You now have a generation who were told as graduates by their bank: we'll make you rich. They weren't taught to think in terms of risk. Basically at banks it's quite simple: if you are generating £100m a year in profits, you can be the biggest arsehole and get away with it.³¹⁶

312 Ev 1170

313 For example, DQq 177, 383,581

314 Ev 943

315 IIA Position Paper, *The three lines of defense in effective risk management and control*, January 2013

316 “The trouble is, regulators are idiots”, *Guardian banking blog*, 10 May 2012, www.guardian.co.uk

Given that the three lines of defence model operates in this environment, it is perhaps not surprising that the examples of its use heard by the Commission were so shambolic.

Dazed and confused

138. Many of those responsible for the three lines of defence system in banks seemed confused by its operation. Mike Walters, the then Group Head of Compliance at Barclays, suggested that compliance was a first line responsibility:

I am in charge of the compliance function, but the first line of defence has responsibility to run its business in a controlled way. It is compliance's responsibility to help that happen. Clearly, here it did not, and that is regrettable, but it is not the compliance function's responsibility to make Barclays compliant.³¹⁷

The new Barclays Head of Compliance and Government and Regulatory Relations, Sir Hector Sants, later told us that he “completely and utterly” disagreed with that statement.³¹⁸

139. Some banks' control frameworks are hardwired with an absence of personal responsibility or accountability. The following question was directed to five senior Standard Chartered executives, including Richard Goulding, the Group Chief Risk Officer:

Mark Garnier:[...] If there is a risk management failure within your organisation, which one of you would the chief executive officer hold responsible?

Don't all rush at once.

Richard Goulding: It would be any of us who are either in the first or second line of defence, according to our model. Both the individual who initiated or incurred the risk and the member of our organisation—up to and including me—who is the second line of defence, would be held jointly accountable.³¹⁹

Michael Roemer, Chief Internal Auditor of Barclays, said similarly, “ultimately, I think, the buck stops, depending upon the issue, across any one of the lines of defence”.³²⁰ This theme was taken up later in the same evidence session with Robert Le Blanc, Chief Risk Officer, Barclays:

Mark Garnier: I am still really struggling to find out where the buck stops.

That is a stony silence. So with none of you, obviously. The board, the regulator, where does the buck stop? Who is taking responsibility for compliance? Who ultimately has their head on the block?

Robert Le Blanc: The executive committee of the bank takes responsibility for all aspects of—

Mark Garnier: So there is no individual.

317 DQ 676

318 Q 2271

319 DQ 123

320 DQ 581

Robert Le Blanc: The individual—let us use risk as an example—

Mark Garnier: The fact is that we have been at this for 20 minutes now and no name has come up. Is it the chairman, is it the chief executive, is it the head of compliance?³²¹

140. Roger Marshall, Chairman of the Institute of Internal Audit Committee on Internal Audit Guidance for Financial Services, told us that the first and second lines of defence “sometimes blur”, with the second line “validating first-line decisions”.³²² An example given by Barclays demonstrated how this can blur responsibility, potentially exonerating front-line staff from mistakes:

Mark Garnier: Is there ever any perception among front-line staff that the control employee—the second line of defence—who approved a bad deal is the more likely to be sacked of the two people than the person who did the deal?

Rich Ricci: No. If there is a bad deal, I think that the buck stops with the business and I think they expect to feel the heat on the deal. I want to be clear, but obviously there are circumstances where if the advice they got was wrong or if there was an issue with the second line of defence in the execution of the deal, that may be different.³²³

Box-ticking

141. Dr Andrew Hilton, Director, Centre for the Study of Financial Innovation, expressed concern that adoption of the fashionable three lines of defence framework was being used as a poor substitute for a genuinely effective control framework:

I worry slightly that—this is an example of Goodhart's law³²⁴—as soon as you put a name to something and you identify it as a clear procedure, it becomes less useful, because it becomes, essentially, a box-ticking exercise. You ask, “Have we done what ‘three lines of defence’ says?”, and so long as you have ticked the boxes, you have met your obligations, whether you are in the first, second or third line.

[...] It reminded me all too much of enterprise risk management from before the crisis. I remember going to a presentation by one of the major consultancies where “enterprise risk management” had a trade mark by it—it was being peddled as a solution from that particular company. “Three lines of defence” is being peddled, I am afraid, in rather the same way—as a solution, when it is really just a box-ticking exercise. In a way, you should forget it. You have got to embed this in the culture of the organisation, whether it is three lines of defence, four lines, or however many—it does not matter.³²⁵

321 DQq 699-701

322 DQ 45

323 DQ 773

324 Goodhart's original formulation was “any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes”. See Charles Goodhart. “Problems of Monetary Management: The U.K. Experience”. Papers in Monetary Economics (Reserve Bank of Australia) I, 1975.

325 DQ 49

As a result of the adoption of the three lines model in process but not in spirit, Dr Hilton added, the system becomes “gameable”.³²⁶

142. Witnesses described adherence to procedure with little regard to judgement throughout the three lines system. Paul Lawrence, Group Head of Internal Audit, HSBC, acknowledged that his department had indulged in box-ticking at the third line:

Baroness Kramer: In a sense, you were not looking at judgment; you were only looking as to whether people had taken the procedural step. Is that what you are saying?

Paul Lawrence: I think that is a fair comment. It is actually very difficult for an audit unit, based on the skill sets it had and where it traditionally was in the organisation, to pass an opinion on judgments or issues of strategy.³²⁷

Joris Luyendijk referred to box-ticking as the second line of defence:

Now, what the trader built was perfectly legal. It would have made money for the bank—or it seemed to make money for the bank. It stayed within all the rules. He probably went to all his compliance people and ticked all the boxes. Most traders talk about compliance as box ticking, or hurdles. They have externalised ethics: once you have got past the priest, you are fine.

Banks tend to have departments tasked with dealing with regulators, enabling the rest of the company to get on with making money. Professor John Kay noted:

If you go into financial institution after financial institution, you will see firstly that regulation is regarded unequivocally as a nuisance, and, secondly, that regulation is largely entrusted to a department whose job it is to deal with regulation, and that department is itself regarded as a nuisance.³²⁸

143. The “three lines of defence” system for controlling risk has been adopted by many banks with the active encouragement of the regulators. It appears to have promoted a wholly misplaced sense of security. Fashionable management school theory appears to have lent undeserved credibility to some chaotic systems. Responsibilities have been blurred, accountability diluted, and officers in risk, compliance and internal audit have lacked the status to challenge front-line staff effectively. Much of the system became a box-ticking exercise whereby processes were followed, but judgement was absent. In the end, everyone loses, particularly customers.

326 DQ 50

327 DQ 408

328 Q 331

Regulation: barking up the wrong tree

Overview

144. The underlying causes of poor banking standards do not lie only in the banks themselves. The financial crisis, individual bank failures and the recent string of conduct failings have all been characterised by poor regulation in the UK and in many other countries. In this section, we consider evidence as some of the underlying flaws in banking regulation and the extent to which they remain.

145. Lord Turner told us that “regulatory failure [was the] supporting mechanism that allowed”³²⁹ the prudential and conduct failings that have led to the collapse in trust in banking standards.³³⁰ A new regulatory regime has since been introduced. Lord Turner told us that the culture of regulation had been fixed:

Chair: [...] I am asking you, one, whether you think there has been something quite seriously wrong with the culture of regulation and, two: has it been fixed?

Lord Turner: Yes, I think it was wrong, and I think it has been fixed.³³¹

146. Martin Wheatley said that “regulatory failure [...] was a failure of philosophy”.³³² As Lord Turner argued, the long periods between banking crises tend to breed complacency in regulators:

The classic problem for human institutions and for the design of our regulatory structures and our policy is how do we design against it in 25 years’ time, when the generation of those who were there in October 2008 are in retirement and we have another: “This time it’s different. This time we’re cleverer than the previous generation.” That is the institutional challenge, and we have got to try and embed the intellectual challenge, the counter point of view—but also try and embed through what we do on structure things which are resilient to changes in intellectual fashion.³³³

This complacency led to regulation which, according to the Leaders’ Statement at the 2009 G20 Summit in London, tended to “amplify the financial and economic cycle”.³³⁴

147. Regulators also showed a tendency to focus on the wrong things. The FSA’s own report on the failure of RBS acknowledged that “discussion of ‘key priority risks’ or of ‘key risks to FSA’s objectives’ were strongly skewed towards conduct issues”.³³⁵ Of the “major topics” discussed at the FSA Board between January 2006 and July 2007, just one out of 61

329 Q 4409

330 Ev 1040

331 Q 4412

332 Q 4413

333 Q 1011

334 G20, *London Summit - Leaders’ Statement*, 3 April 2009

335 FSA Board Report, *The failure of the Royal Bank of Scotland*, December 2011, p 264

related in some way to bank prudential risks and issues.³³⁶ Despite this supposed focus on conduct prior to the crisis, it was during this period that much of the poor behaviour leading to later conduct scandals also occurred. In this section, we examine the ways in which regulatory failures contributed to poor standards. We consider the regulatory and supervisory approach further in Chapter 9.

A tendency towards rules and complexity

Judgement versus rules

148. Andrew Bailey described the new PRA approach in his evidence to the Treasury Committee as one where “supervisors concentrate on the biggest risks to our statutory objectives posed by the firm, rather than pursuing a myriad of issues that in some cases resulted in the FSA being more like an internal audit function than a regulator”.³³⁷ These comments echoed those made at the formal launch of the FSA by its then Chairman, Sir Howard Davies, in November 2001:

We need to alter the way we deal with firms. We don’t want—and they don’t want—a box checking routine. Our risk-based approach should ensure that in future, when we visit a firm we have a clear purpose in doing so.³³⁸

Michael Foot told us that prudential matters lend themselves to judgement-based supervision, but that regulating conduct tended to involve more rules:

there are very different roles for the rules-based and judgment supervision in the different areas of the business. On the prudential side, for example, there is an awful lot of judgment that is required. In some of the areas like conduct of business or maybe anti-money laundering, the role for rules is significantly greater.³³⁹

149. When asked how he would ensure that the FCA would pursue judgement-based regulation, Martin Wheatley acknowledged that the FCA was at the mercy of the wider mood and that criticism of it could encourage box-ticking:

[...] individuals obviously respond to the stimuli that they are given and, at the moment, those stimuli—this is the messaging from me, from Parliament and, I think, from Ministers—are that we want a different style of regulation. At the moment, I think that we are seeing people responding to that. If there is heavy criticism—if things are not perfect and if some decisions are not as some people would want - there would be a tendency for people to want to revert away from taking the risk of making judgments.³⁴⁰ Which? warned that the regulator’s confidence and willingness to take action has been affected by political influence in the past:

336 FSA Board Report, *The failure of the Royal Bank of Scotland*, December 2011, p 264

337 Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 10, www.bankofengland.co.uk

338 FSA, Speech by Sir Howard Davies to the Foreign Banks and Securities Houses Association Conference, 29 November 2001

339 BQ 55

340 Q 213

the political environment in which the regulator was operating also played a part in its failure to take action to protect consumers and to enforce high professional standards. Politicians on all sides queued up to criticise the regulator as promoting ‘chronic overregulation’, inhibiting ‘efficient businesses’ or undermining the competitiveness of the UK as a location for financial services.³⁴¹

Complexity

150. Andy Haldane argued that the adoption of complex regulatory rules reinforced a tendency towards box-ticking, telling us that “one of the incentive costs of having a very detailed and complex rule book is that you cannot be seen to override it with your own judgment”.³⁴² He continued by suggesting that the way to ensure regulators “act less defensively and in a way that protects the system rather than themselves is sometimes to give them more discretion and fewer rules to play with in the first place”.³⁴³ Douglas Flint warned of a tendency to have faith in the outputs of models because they are “thought to have been constructed with huge intellectual rigour whereas a common-sense approach might say that it doesn’t make sense”.³⁴⁴

151. Thomas Huertas told us that complexity in banking regulation may be necessary because banking itself is complicated.³⁴⁵ Andy Haldane has argued, however, that “As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity, not complexity”.³⁴⁶ Sir David Walker also argued that “responding to complexity in banking with more complex rules” is a mistake because “people in investment banking and elsewhere are pretty clever, and if you set out a rule these people are very good at devising ways around it”.³⁴⁷ Andrew Bailey concurred that the “industry is tremendously innovative in thinking of ways to dress things up to look slightly different” to satisfy the detail, but not the spirit, of complex regulations.³⁴⁸ Carol Sergeant told us that excessive complexity in regulation impeded its effectiveness by giving “an invitation for clever people to game” the system.³⁴⁹ The Basel II and Basel III capital regimes were often cited as examples of excessive complexity in evidence to the Commission. We discuss the Basel III regime further in Chapter 9.

341 Ev 1464

342 Q 638

343 Q 639

344 Q 3853

345 EQ 49

346 Bank of England, *The dog and the Frisbee speech*, Andy Haldane, 31 August 2012

347 Q 48

348 Q 976

349 EQ 99

The role of supervisors

An anti-competitive instinct

152. In his 2000 review of competition in banking, Sir Donald Cruickshank referred to the “old regulatory contract”:³⁵⁰

an informal contract between successive governments and banks, designed to deliver public confidence in the banking system. In return for cooperating in the delivery of Government objectives, the banking industry escaped the rigours of effective competition. This contract cannot coexist with desirable levels of innovation, competition and efficiency in UK banking markets.³⁵¹

John Kay argued that the vestiges of the regulatory contract remain:

throughout the 20th century, we maintained stability in British banking through oligopoly, with minimal competition, no new entry and no banking failure of any significance. Perhaps that was a good bargain: but whether or not it was, it is a bargain that is no longer available. Now we have lost the assurance of stability, but experience fully the disadvantages of oligopoly.³⁵²

Michael Foot observed that regulators are “very risk averse”, which tended to act against authorising new entrant banks. He explained that allowing a small or innovative entrant to fail “should actually be beneficial for the system” from a “competition and culture point of view”.³⁵³ John Kay explained that regulators tended instinctively to favour the familiar:

There is a very real phenomenon of what you have described as regulatory comfort. At the moment we are in the process of encouraging people to establish new banks, but implicitly and explicitly we say, “If you are going to be a new bank, you have to be pretty similar to an existing bank.”³⁵⁴

153. Diane Coyle, founder of Enlightenment Economics and a former member of the Competition Commission, explained that “regulators tend to regulate and they do not think about competition as a tool that they can use”.³⁵⁵ John Fingleton added that “when you are a regulator, you are probably over-confident about the ability of regulation to solve every problem”.³⁵⁶

350 The Banking Review, *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, March 2000, para 2.14

351 *Ibid.* para 4

352 ‘It is time to end the oligopoly in banking’, *The Financial Times*, 8 May 2012, www.ft.com

353 EQ 58

354 Q 334

355 Q 2327

356 Q 2328

Absolving management of responsibility

154. Michael Cohrs told us that he was “not optimistic that you can change the culture of an institution through regulation” and that regulators could merely “create the right incentives and hope”.³⁵⁷ Andrew Bailey warned of bank management seeking to “outsource” cultural change to regulators, stating that it would be “an abandonment of responsibility”.³⁵⁸ The Salz Review of Barclays Bank agreed that regulators were not equipped to change banking culture:

It is understandable, and in many respects necessary, that since the start of the financial crisis, there has been an explosion in new regulation and in the intrusiveness of regulators. However, regulation alone cannot address the fundamental underlying causes that led to the business practices which are in the spotlight – the cultural shortcomings we found.³⁵⁹

Hermes Equity Ownership Services wrote that they were concerned that, following the financial crisis, FSA regulators erred towards being over-intrusive “shadow directors”. This encouraged a culture in banks of narrow compliance with rules:

The risk is that rules will inevitably lead to formal, legal compliance with the letter rather than the spirit of the law or regulation. In turn this leads to behaviour that is focused on formal, defensive compliance (which easily drifts into a gaming of the system) rather than the sort of culture and approach that we should all be seeking, which is a dynamic of seeking improvement within appropriate risk parameters rather than mere compliance.³⁶⁰

155. Which? described a culture where strict conformance with regulation was used as a substitute for standards:

In too many banks a “tick-box” culture developed which saw regulation or regulators as the only arbiters of acceptable behaviour. We are aware of an instance where a firm identified “no major FSA concerns” and “no major regulatory sanctions threatened” as the only indicators that senior managers had met their target of treating customers fairly.³⁶¹

Peter Vicary-Smith explained that banks took this approach to PPI:

they were so embodied in a culture that, as long as they did exactly what the FSA told them to and ticked the box, they did not have to worry about anything else. In a sense, what we need is the banks to grow up. The analogy I use is that, when my children were five, I used to tell them what to do. Now they are 18, I expect them to use some judgment of their own interpretation and behave with integrity and so on.

357 BQ 3

358 Q 4556

359 Salz review: *An independent Review of Barclays' Business Practices*, April 2013, para 2.14

360 Ev 1112

361 Ev 1457

But the banks still seem to be happier in the culture in which as long as they comply with exactly what the regulator says, they do not have to worry about anything else.³⁶²

Clive Briault, former Managing Director of Retail Markets, FSA, explained that the regulator was complicit in this absolution of responsibility, stating that the “extension of the rules was very much at the FSA’s initiative”.³⁶³

The quality of regulators

156. Regulators are not remotely as well paid as the regulated. Michael Foot used a football analogy:

The way I used to put it, certainly in my Bank of England days when Wimbledon were in what was then the premier league, was that I played with a team like Wimbledon that had been put together out of people who nobody else would look at. I didn’t have any money to buy star players.³⁶⁴

Douglas Flint praised the “intellectual qualities” of the staff at the Bank of England and the Treasury, but expressed concern about the “depth of talent”. He cited the example of Singapore, which had been successful by paying regulators salaries “equivalent to those they are regulating”.³⁶⁵

157. Several former regulators told us that the pay differential was not a major problem. Lord Turner said that “the institutional ethos and the fascination with the job” compensated for “a significant period of time”.³⁶⁶ Carol Sergeant, a former Managing Director of the FSA who later joined Lloyds Banking Group, said that regulators offer “extremely interesting jobs that are, actually, jolly well paid”.³⁶⁷ Douglas Flint suggested that the “intellectual quality” of regulatory work was a determinant of the quality of staff:

If the role of the supervisor is much more to be high-level, understanding of the risks, and dealing at a senior level in organisations, that is a much more interesting career than the kind of much more minute data gathering, sticking it into a matrix and determining whether it comes out right. I think if the intellectual quality of the role is higher you will get better people.³⁶⁸

Sir Mervyn King told us that intellectually demanding work was more likely to fall on the prudential, rather than conduct, side:

the two styles of regulation are naturally very different. One is naturally a compliance-driven style and the other is inevitably, or should be, in my view, a very

362 JQ 15

363 JQ 176

364 EQ 61

365 Q 3851

366 Q 4490

367 EQ 109

368 Q 3855

close and careful look at the balance sheet risks of those institutions and judgements made by the regulator.³⁶⁹

158. 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.

A lack of market discipline

Competition and standards

159. Andrew Lilico, Director of Europe Economics, argued that there needed to be more focus on competition, and less on regulation, in improving banking standards:

Any level of regulatory oversight sufficient, by itself, to maintain high standards in an industry as complex and multi-faceted as banking will almost inevitably involve such onerous intervention as to stifle the healthy functioning of the sector. It is simply a delusion to imagine that in a modern economy, in which banks are the main allocators of capital, regulatory supervision could ever be the main mechanism to maintain standards.³⁷⁰

Dr Diane Coyle agreed that competition was “less direct [...] but [...] more effective” than regulation in raising standards.³⁷¹ Clare Spottiswoode outlined how competition could act to improve culture in banking:

People move their custom if you do not provide a good service with a good product at a good price. If you do not do these things well, you lose your customers. Customers become the heart of your business [...] It is not that competition deals with culture directly; it is that if you have a bad culture, you do not succeed. It is an indirect and really strong impact of good competition.³⁷²

Competition is clearly, however, not a cure-all solution to banking standards problems. Many areas of investment banking are highly competitive, but it has been the home of many of the most egregious failings of banking standards, including LIBOR manipulation.

369 Seventh Report from the Treasury Committee, Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals*, HC 430-II, Q 8

370 Ev 1205

371 Q 2321

372 Q 2361

In this section, we examine contributory factors to a lack of competitive pressure to improve banking standards.

Concentration and choice

160. Earlier in this chapter, we established that banks have incentives to become very large. This is partly due to the implicit taxpayer guarantee which, as the New Economics Foundation wrote, “accrues almost entirely to the largest banks and acts as a significant distortion to market competition and a barrier to new entrants”.³⁷³ By definition, it also acts as a barrier to exit: a major incumbent will not be permitted to fail and leave the market. We also referred to incentives for regulators to favour major, established banks. These factors have helped to sustain highly concentrated markets in parts of banking.

161. Two crucial markets, personal current accounts (PCAs) and SME banking, are particularly concentrated and have become more concentrated in recent years,³⁷⁴ a process prompted by a series of mergers during the financial crisis. The PCA market is the cornerstone of the UK's retail finance system: 94 per cent of UK adults have at least one,³⁷⁵ and they act as “gateway” to other products.³⁷⁶ The four large providers now have “around 75 per cent” of the market.³⁷⁷ The SME banking market is yet more concentrated,³⁷⁸ and in some geographical areas there is no choice at all. David Richardson, Federation of Small Businesses Development Manager for Highlands and Islands, told us that “banks take a like it or lump it approach” to small businesses because “the customers have no choice or very little choice”.³⁷⁹ These markets exhibit many of the symptoms of oligopoly (see Box 6).

Box 6: Oligopoly

An oligopoly is a market dominated by a small number of firms. In an oligopolistic market, an individual firm can influence the market price. This means that firms are interdependent and their interactions are strategic.

Oligopolies tend to result in poor outcomes for consumers. Firms in oligopolies have incentives to collude to extract economic rent, through, for example, resisting the market entry of potential competitors. Even if firms do not collude, the market can bear the hallmarks of an apparent cartel. Prices in oligopolies can be notoriously sticky: competitors will tend to match a price cut (as demonstrated in a baked bean “price war”), but not a price rise. As a result, the incentives to compete on price can be very limited. Instead, firms in oligopolies tend to focus on non-price competition. It is no coincidence that advertising, brand differentiation and customer loyalty schemes are so common in oligopolistic markets.

373 FR Ev 186

374 Independent Commission on Banking, Final Report, September 2011, p167

375 OFT, *Review of the personal current account market*, January 2013, p27

376 Ev 1427

377 OFT, *Review of the personal current account market*, January 2013, p4

378 Independent Commission on Banking, Final Report, September 2011, p 167

379 IQ 10

Oligopolistic markets are not necessarily bad for consumers. Some such markets are highly competitive, with supermarkets a commonly used example. In such circumstances, economies of scale can be passed on to customers.

162. Sir Donald Cruickshank told us that market concentration in itself is not deterministic of competition.³⁸⁰ Many concentrated markets are very competitive.³⁸¹ Lloyds Banking Group argued that UK banking is one of them:

The level and effectiveness of competition in retail and wholesale banking markets (domestically and internationally) is not a cause of any alleged problems for professional standards in UK banking. On the contrary, the ‘virtuous circle’ (by which consumers can access and assess products and services and then act by switching supplier if they are dissatisfied or a better offer is available) drives competition and helps maintain professional standards.³⁸²

Just three per cent of consumers switch their main current accounts over a twelve month period.³⁸³ Benny Higgins, Chief Executive of Tesco bank, suggested that low switching rates could indicate that “many people are actually happy with the bank they are banking with”.³⁸⁴ However, there are other potential explanations. Diane Coyle suggested that customers do not switch because of the risk of “something that is very disruptive to their lives going wrong”, especially given that the service to which they would be switching would be “very similar to the service that they would be leaving”.³⁸⁵

163. Lloyds Banking Group, in a 2011 submission to the Treasury Committee, argued that there was “no correlation between concentration and consumer outcomes”.³⁸⁶ They suggested that, if presented with a superior offer to the incumbent banks, customers would be equipped to exercise choice:

Whilst new entrants and smaller competitors might have some difficulty in expanding their market share very rapidly if they followed similar competitive/pricing strategies as incumbents, the ICB has presented no evidence to suggest that consumers are inert or unresponsive when a competitor does something more innovative or radically different.³⁸⁷

164. John Kay argued that banks perceive the market to be very competitive, but this does not result in improved service and choice for customers:

We have the paradox in banking at the moment—if you talk to people in Lloyds and HSBC, on the ground, they will describe their business as incredibly competitive, and

380 Q 194

381 Independent Commission on Banking, Final Report, September 2011, p 171

382 Ev 1221

383 OFT, *Review of the personal current account market*, January 2013, p101

384 FQ 63

385 Q 2333

386 Treasury Committee, Nineteenth Report of Session 2010–12, *Independent Commission on Banking Standards*, HC1069-II, Ev 64

387 *Ibid.*

you sort of see what they mean. But it doesn't look competitive to you and me, because we regard these institutions as being, almost, difficult to distinguish from each other. A way I put in once was to say that the competition between Tweedledum and Tweedledee matters a lot to Tweedledum and Tweedledee, but not to anyone else.³⁸⁸

Diane Coyle made a similar point, linking illusory competition back to market structure:

If you talk to bankers they will say that it is a very competitive industry—competition is very fierce. What they are thinking about is having to get products into the best-buy tables, and offer very good interest rates, and so forth. That is classic oligopolistic rivalry, where they are competing on a narrow range of products for a small group of customers. That is subsidised by high margins on other products in uncompetitive areas of the business. I think the language that they use for consumers who shop around to get the best interest rates is quite revealing. They call them rate tarts.³⁸⁹

Barriers to entry

165. John Fingleton identified market entry, alongside switching, as one of the potential “fundamental drivers of competition” in banking markets.³⁹⁰ A wide range of barriers to entry were identified to us, which made it, according to Sir Donald Cruickshank, “extraordinarily difficult for a genuine new entrant to come into this marketplace”.³⁹¹ Earlier in this chapter, we referred to instinctive regulator opposition to competition. Regulatory barriers to entry included:

- a lengthy authorisation process with limited support from the FSA;³⁹²
- capital and liquidity requirements that put new entrants at a disadvantage compared with large incumbents;³⁹³ and
- the Catch-22 situation whereby the FSA will not authorise a new bank until it has the appropriate people, processes and infrastructure in place, while investors are reluctant to commit resources or staff to join the bank until a licence has been secured.³⁹⁴

The FSA published a review of barriers to entry in March 2013.³⁹⁵ In Chapter 5 we consider the extent to which the measures proposed address these issues.

166. Clare Spottiswoode explained that arrangements for access to the payments system also acted as a barrier to entry:

388 Q 349

389 Q 2321

390 Q 2322

391 Q 167

392 Q 134

393 FQq 1-3

394 Q 234

395 FSA, *A review of requirements for firms entering into or expanding in the banking sector*, March 2013

It is undoubtedly the case that it is really expensive and difficult to access our payments systems at the moment. If you are a challenger bank, there is a huge up-front cost of getting your IT systems in place and an additional huge cost of getting your own access to the schemes. Most challenger banks go via another competitor, which is a terrible way.³⁹⁶

Crowdbnk wrote that the internet was opening up opportunities for new entrants to provide financial services with low sunk costs.³⁹⁷ However, Clive Maxwell stressed the continued importance of a branch network, stating “despite the fact that internet and even mobile access to personal current accounts has increased very rapidly over the past few years [...] if you want to have a large-scale presence you need a large-scale branch network to go with it”.³⁹⁸

167. Retail banking is characterised by high market concentration and substantial barriers to entry. The limited switching between providers can be seen as a symptom of this. There is insufficient market discipline on banks to reduce prices and improve service. This lack of competition, compounded by generally low levels of customer understanding of financial products and services, is an important reason why banks can sustain poor standards of conduct and do not seem to feel the same pressure to respond to reputational damage as would be the case in many other industries.

A mismatch of information

168. The FSA noted in written evidence that a lack of knowledge and information acted as a further barrier to effective competition:

Asymmetries of information and knowledge between consumers and providers and the fact that infrequent purchases and barriers to switching reduce the ability of customers to exercise market discipline via consumer choice.

The complexity of many banking products makes assessing their quality difficult. Martin Taylor referred to “gigantic information asymmetry in retail banking” where “the customer knows a fiftieth as much about the product as the person selling it to them does”.³⁹⁹ This is partly attributable to a lack of financial literacy in the population. Clive Maxwell spoke of “consumers who find it difficult to understand the products and the services that they are being offered”.⁴⁰⁰

169. As a result of information asymmetries, the FSA said that “there is greater potential for customers [...] to be exploited in financial services than in other sectors of the economy”.⁴⁰¹ This can apply even in ostensibly competitive markets. In Chapter 2 we gave an example of confusing terms for mortgages. The ABI told us that fee structures for

396 Q 2370

397 F Ev 92

398 Q 3074

399 Q 365

400 Q 3075

401 Ev 1039

investment banking are often so complex that supposedly “sophisticated” corporate customers can be confused:

even large and sophisticated companies have entered into a complex series of transactions (often with a simple underlying intent), but where the risks have not been fully understood and where the immediate profit for banks on the derivative component(s) of the transaction is unclear—and may be large.⁴⁰²

The Association of Corporate Treasurers explained that cross-selling of investment banking products adds to the opacity of pricing:

The “bundling” of services by banks such that they “price for the relationship” means that, while a company may be separately invoiced for particular services, it actually has little idea what it is really paying for any particular service.⁴⁰³

170. Cross-selling is, of course, not restricted to investment banking. Lord Turner told the Treasury Committee that the free-in-credit current account was “essentially a loss leader, [...] a classic loss leader, or at least a low return leader”, which banks provided in order to “get hold of a relationship on which they can then sell other products”.⁴⁰⁴ In Chapter 2, we described the mis-selling of often bundled retail products such as interest rate swaps and PPI. Dominic Lindley told the Commission that the typical pay-out rate for PPI was “between 11 per cent and 25 per cent for a PPI, compared with a motor insurance pay-out rate of around 80 per cent”.⁴⁰⁵ A properly functioning market would have driven out such poor value.

171. Peter Vicary Smith told us that “the reason why there is a need for greater literacy is in part because the products that are presented are needlessly complicated”.⁴⁰⁶ Antonio Simoes, Head of UK Retail Banking, HSBC, acknowledged that it took “an hour and a half” to read the terms and conditions for a current account.⁴⁰⁷ Referring to interest rate swaps, Abhishek Sachdev explained that there was nowhere for SMEs to go for advice on a complex product: they were sold to unsuspecting customers on “an execution only basis”.⁴⁰⁸ Clive Maxwell told us:

I am not yet convinced that banks are sufficiently focused on delivering the sorts of products and services that their customers really want, as opposed to finding ways to charge them for things that they do not necessarily want.⁴⁰⁹

172. Customers are often ill-placed to judge the value of banking services that they are offered. Banks have incentives to take advantage of these customers by adding layers of complexity to products. A good deal of the innovation in the banking industry makes

402 G Ev 22

403 G Ev 26

404 Treasury Committee, Ninth Report of Session 2010-11, *Competition and choice in banking*, HC1069-II, Q48

405 JQ 40

406 JQ 23

407 DQ 509

408 AQ 112

409 Q 3070

products and pricing structures more complex, hindering the ability of consumers to understand and compare the different products. Regulators and banks need to ensure that information provided is crystal clear to enable comparison and choice.

Incentives to pull in the wrong direction

The role of shareholders

173. Earlier in this chapter, we noted that the implicit taxpayer guarantee provided to bank creditors creates incentives for banks to pursue financial returns founded on high leverage. However, their liability is limited to the size of their investment while the upside is potentially unlimited. This encourages shareholders to advocate increased leverage in search of growth in times of economic buoyancy. John Kay noted that these incentives are particularly strong in banks, where leverage can act to limit shareholders to a very small proportion of bank liabilities:

If we look at our banks they are unique among large companies in that the equity shareholders in reality only provide 2 per cent or 3 per cent of the capital of the business in many cases.⁴¹⁰

Professor Kay likened the interest of such shareholders in banks to that of an option holder in a non-financial company, being prepared to risk their investment for the upside the additional gearing provides. Professors Black and Kershaw noted that it was rational for shareholders to encourage managers to “bet the bank”,⁴¹¹ particularly if they thought that they were smart enough to get out before the ensuing crash. As a result, Professor Kay suggested, shareholders are “not the best people to control” bank risk-taking.⁴¹²

174. Some banks told us that shareholders had put pressure on management to increase leverage. RBS told us that “in some instances investors pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk”.⁴¹³ Douglas Flint told the Treasury Committee that:

there was a great deal of pressure coming from shareholders who were looking for enhanced returns and were pointing to business models that have, with hindsight, been shown to be flawed and in particular very leveraged business models and saying, “You guys are inefficient. You have a lazy balance sheet. There are people out there that are doing much better than you are”, and there was tremendous pressure during 2006/2007.⁴¹⁴

Professors Black and Kershaw explained that pursuing a risky strategy was in accordance with bank directors’ responsibility to shareholders:

410 Q 344

411 Ev 831

412 Q 344

413 Ev 1324

414 Treasury Committee, Ninth Report of Session 2010–11, *Competition and choice in retail banking*, HC 612, Qq 833-835

For managers whose are required to promote the success of the company for the benefit of the shareholders they comply with their duties if they increase the banks risk profile at the expense of the ultimate non-adjusting creditor—the state.⁴¹⁵

175. Incentives to pursue leveraged short-term growth conflict with concepts of “stewardship” roles of shareholders focused on the long-term interests of the company. This clash is exacerbated by the reduction in the average holding period for shares, shifts in the profile of UK share ownership away from long-term investors in fundamentals,⁴¹⁶ and pressure on investment fund managers to generate short-term returns.⁴¹⁷ As Sir David Walker summarised, there was a widespread desire for shareholders to take “more long-term views [...] in line with the [...] the stewardship code”, but this “will not happen overnight, and it may never happen”.⁴¹⁸ This may reflect the distinction between the underlying investors in a pension fund or a collective investment, and the institutional investors and asset managers whose own incentives and remuneration structures may diverge from the long-term interests of the ultimate beneficiaries. These issues are explored in further detail in Chapter 7. Shareholders also exercised inadequate oversight of the conduct of business standards within banks. They ignored concerns raised about widespread mis-selling of PPI. Helen Weir of Lloyds Banking Group said that she could not recall PPI selling standards ever being raised by shareholders.⁴¹⁹

176. Shareholders are ill-equipped to hold bank boards to account. In particular, institutional shareholders have incentives to encourage directors to pursue high risk strategies in pursuit of short-term returns and ignore warnings about mis-selling. Nonetheless, shareholder pressure is not an excuse for the reckless short-termism witnessed over recent years. Boards and senior management have shown a considerable capacity to ignore shareholders’ interests when it has suited them.

Conflicts and complacency in external assessment

Audit and accountancy

177. Auditors are intended to provide checks and balances in the financial system. In evidence to the House of Lords Economic Affairs Committee in 2011, a representative of Hermes Investments said that “audit and accountancy are absolutely fundamental to the integrity of our capital markets and the good governance of our companies”.⁴²⁰ However, that Committee concluded that “the complacency of bank auditors was a significant contributory factor” in the financial crisis.⁴²¹ Evidence collected by the Commission pointed to the existence of potential conflicts of interest that meant that, at best, auditors

415 Ev 831

416 See, for example, *The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report*, July 2012

417 Treasury Committee, Ninth Report of Session 2010–11, *Competition and choice in retail banking*, HC 612, Q 834

418 Q 3628

419 Q 671

420 Economic Affairs Committee, Second Report of Session 2010–12, *Auditors: Market concentration and their role*, HL 119, para 2

421 *Ibid.* para 167

did not act as the last line of defence against banks' questionable reporting on their own businesses and, at worst, they were cheerleaders for it.⁴²²

178. Various reasons for a tendency towards insufficient challenge have been suggested. The FSA noted a tendency for auditors to take a narrow, box-ticking approach of assessing whether transactions are “clearly inconsistent with accounting standards” rather than applying professional scepticism.⁴²³ Hans Hoogervorst, Chairman of the International Accounting Standards Board (IASB), told the Commission that auditors tended misguidedly to rely on regulators to identify problems:

auditors do their work in a world where everybody thinks that the situation in the world is hunky-dory [...] I think that the auditors were relying on the regulators to take care of going concern, to tell you the truth. That's a reason why they were not so very critical. I think they need to be more critical.⁴²⁴

This problem was exacerbated if auditors and regulators failed to communicate. Andy Haldane drew attention to the conflicts created by the accounts qualification system:

One of the problems that auditors face at the moment, particularly when evaluating the solvency position of banks, is that they have to reach a rather binary judgment on whether to qualify the accounts or not. That puts them in a rather invidious position, because were they to qualify the financial accounts of a bank, it would almost certainly trigger a run.⁴²⁵

In addition, some respondents suggested that the conflicts of interest created by the cross-selling of consultancy services by auditing firms further reduced incentives to expose poor practice.⁴²⁶

179. Auditors are required to work within the framework of the accounting system. Since 2005, use of International Financial Reporting Standards (IFRS), which have been adopted into EU law, has been mandatory for the consolidated accounts of publicly-listed companies.⁴²⁷ Several witnesses told us of a desire for consistent application of IFRS that might have led to an overly simplistic and rigid approach at the expense of professional judgement.⁴²⁸ In a recent report, the FSA noted:

in some complex transactions structured to achieve a particular accounting treatment, auditors did not always appear to be willing to robustly challenge key—and at least debateable—accounting judgments made by management, which were fundamental to the transaction. Sometimes there is little evidence that the audit firm has discussed with its client whether the overall accounting presentation of the transaction, as constructed, was appropriate. In some cases, auditors appear to apply

422 HQq 188 -200

423 FSA and FRC, *Enhancing the auditor's contribution to prudential regulation*, DP10/3, FSA/FRC, June 2010, Para 3.41

424 HQ 92

425 HQ 108

426 See, for example, Ev 1381,1443

427 H Ev 235

428 HQq 133, 309, 389

only a weaker test of whether or not something is clearly inconsistent with accounting standards. In our view, this approach is not likely to result in high quality reporting or auditing.⁴²⁹

Evidence submitted by a consortium of investors threw doubt on the ability of IFRS compliant accounts to be consistent with the ‘true and fair’ principle.⁴³⁰ Martin Taylor expressed concern that the mandatory use in valuing assets of the incurred loss model, which had been widely interpreted as implying that default has to occur before provision can be made for the likely loss, was not consistent with prudent accounting.⁴³¹

180. The valuation of certain financial instruments on a “fair value” basis under IFRS has been singled out for criticism, though its defenders argue that there is no realistic alternative when up-to-date valuations of assets are required.⁴³² Fair value is generally obtained by marking to market (valuing it at its current market price), which can be difficult if there is no liquid market in the type of asset held, or to model (valuing it at a price determined by a financial model). This enables unrealised profits to be booked and, potentially, fed through to dividend and bonus pools,⁴³³ arguably creating incentives for banks and bankers to concoct elaborate schemes to artificially inflate asset values.⁴³⁴ In a speech in 2011, Andy Haldane explained the pro-cyclical effects of fair-value accounting:

In sum, accounting rules in general, and fair value principles in particular, appear to have played a role in both over-egging the financial upswing and elongating the financial downswing. They have tended to over-emphasise return in the boom and under-emphasise risk in the bust. That is not a prudent approach. Indeed, it is a pro-cyclical one. We need accounting rules for banks which are crisis-neutral, valuation conventions for all seasons.⁴³⁵

181. Auditors and accounting standards have a duty to ensure the provision of accurate information to shareholders and others about companies’ financial positions. They fell down in that duty. Auditors failed to act decisively and fully to expose risks being added to balance sheets throughout the period of highly leveraged banking expansion. Audited accounts conspicuously failed accurately to inform their users about the financial condition of banks.

Rating agencies

182. The credit rating agencies were “essential cogs in the wheel of financial destruction”.⁴³⁶ During our investigation of the failure of HBOS, several witnesses admitted to taking

429 FSA and FRC, *Enhancing the auditor’s contribution to prudential regulation*, DP10/3, June 2010, para 3.41

430 H Ev 236

431 Q 2947

432 H Ev 75, 112, 304, 314

433 HQq 36–7, 103

434 H Ev 262

435 Bank of England, *Accounting for Bank Uncertainty* speech, Andy Haldane, 19 December 2011

436 National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Commission: Final Report*, January 2011, p xxv, www.gpo.gov

glowing references for dubious assets at face value.⁴³⁷ The failure of the rating agency model derives from the inherent conflict of interest whereby rated companies pay for their own ratings. As a result, ratings agencies had incentives to underestimate the riskiness of assets. A representative of Moody's told the Treasury Committee that rating agencies would compete for business on the basis of generous ratings:

you had what is so-called rating shopping where underwriters would approach different rating agencies and, to the extent that one or two rating agencies were not in a position to achieve the rating desired, they would not work with that rating agency.⁴³⁸

183. Recent research suggests that exposure of this problem has not led to its eradication.⁴³⁹ In an article in *The Financial Times*, Arturo Cifuentes said that the ratings agency sector was little changed since the crisis:

The fact remains that five years after the onset of the subprime crisis, the rating agencies still control the fixed-income market. Far worse, the three agencies that dominated the market before the crisis (S&P, Moody's, and Fitch) still do so.⁴⁴⁰

A European Securities and Markets Authority report found that while progress had been made in “integrity, transparency, responsibility and good governance” credit rating agencies “have not sufficiently embedded in their organisations those changes necessary to address the concerns about the conflicts inherent in [their] business models”.⁴⁴¹

184. It is widely held that credit rating agencies have business models founded on a conflict of interest, whereby in most cases they are paid by those who issue the financial products of which the agencies purport to be the dispassionate assessors. The industry also contains a barrier to entry which reduces competition in the ratings industry: issuers are often unwilling to deal with a number of agencies, and many issuers believe that investors will want ratings by the well-known firms. This entrenches the position of the three main agencies who continue to dominate the market, notwithstanding their chequered forecasting record. There have been insufficient signs of change. This would matter less if the agencies were viewed as just another source of opinion, but their ratings have come to enjoy an unwarranted status. This is because rating agency scorings offer a convenient shorthand to describe risk, not just for market participants, but particularly for the regulators.

437 BQ 179, 270-276

438 Uncorrected transcript of oral evidence taken before the Treasury Committee on 7 March 2012, HC (Session 2010–12) 1866-ii, Q240

439 Cynthia E. Clark and Sue Newell, “Institutional Work and Complicit Decoupling across the U.S. Capital Markets: The Work of Rating Agencies”, *Business Ethics Quarterly*, Vol 23 (2013), Issue 1

440 “Get technical to fix rating agencies”, *The Financial Times*, 4 March 2013, www.ft.com

441 “ESMA requires further improvements by CRAs”, European Securities and Markets Authority press release, 18 March 2013, www.esma.europa.eu

The wrong tax incentives

185. The UK tax system, in line with international norms,⁴⁴² has long incentivised the use of debt over equity by allowing interest to be deductible against profits, while dividends are distributed from post-tax profits. Professor Mike Devereux, Director of the Oxford University Centre for Business Taxation, told us that there was “no good reason why debt and equity should be treated differently by the tax system as a matter of principle” and that the bias “creates a number of distortions” in the behaviour of banks.⁴⁴³

186. Sir Mervyn King explained the tax bias in favour of debt could act to encourage high leverage:

One of the arguments that banks can put forward for saying that it is good for the shareholders to have more leverage is that there is a tax advantage to use debt finance rather than equity.⁴⁴⁴

The International Monetary Fund submitted that, while there was a link between the tax bias towards debt and leverage, it could not conclusively be said that that had a material effect on banks’ leverage across the world in the lead-up to the financial crisis. However, the IMF suggested that this did not mean tax should be dismissed as an issue, because “even small changes in the leverage of very large banks could have a large impact on the likelihood of their distress or failure, and hence on the likelihood of financial crisis”.⁴⁴⁵ Professor Mike Devereux concurred that, while tax was not the main cause of “the sharp increase in leverage that led to the crisis”, it was “certainly there as a factor”.⁴⁴⁶

187. Ernst and Young highlighted that the tax system was not “aligned to incentivise similar behaviour to regulation”, meaning that complying with regulations could “penalise banks from a tax perspective”.⁴⁴⁷ Andy Haldane argued that the tax system was pulling in the opposite direction to regulatory capital requirements, meaning that regulators were “trying to induce banks to do something that the tax system at present provides a disincentive to do, which is to raise extra equity”.⁴⁴⁸ He added that a more neutral tax system would “lessen the burden on this complex regulation”.⁴⁴⁹

188. The tax bias that incentivises companies to favour debt over equity did not by itself cause the financial crisis. The scale of its impact on the incentives for banks to become highly leveraged is unclear. But, at the very least, having a tax system that encourages banks to take on more risk certainly does not help. The more forces that are pulling in the wrong direction, the more difficult it is to design the regulation required to restrain them.

442 HQ 5

443 HQ 1

444 Q 4581

445 H Ev 256-257

446 HQ 6

447 H Ev 184

448 HQ 114

449 *Ibid.*

Levers of power

189. In our First Report we noted the effectiveness of the banks in lobbying politicians and warned that this could have pro-cyclical effects:

The characteristics of financial crises and the nexus between banks, politicians and regulators together pose fundamental challenges for the design and implementation of structural separation. Any framework will need to be sufficiently robust and durable to withstand the pro-cyclical pressures in a future banking cycle. [...] Politicians need to face up to the possibility that they may prefer those siren voices to the precautionary approach of regulators, particularly if, once again, it appears that banks are performing alchemy.⁴⁵⁰

Adam Posen observed that UK Governments have tended to reserve special support for the banking industry, describing it as a “fetish”:

Governments who promote particular industries [...] tend to distort political decision-making and tend to distort the incentives for that industry to behave. Every major economy has its protected industry that gets romanticised. In the US it’s usually agriculture; in France it’s agriculture; in Japan it’s rice farming, even though they don’t eat rice that much any more; in Germany it’s automobiles—pick your country, pick your poison. In the UK, however, and this is where it makes it worse, the fetish is banking.⁴⁵¹

Sir Mervyn King told the Treasury Committee “not to expect too much from regulators” not least because of the political constraints they operate under:

The real problem that any of them would have faced was that if they had said to banks in the City before 2007, “You are taking big risks”, they would have been seen to be arguing against success. [...] they would have been confronted with this massively difficult task of actually persuading people, persuading you, that they should have been taking action against institutions that looked very successful and highly profitable. [...] Any bank that had been threatened by a regulator because it was taking excessive risks would have had PR machines out in full force, Westminster and the Government would have been lobbied, it would have been a pretty lonely job being a regulator.

190. 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.

450 First Report, para 78

451 JustBanking, *Keynote speech*, Adam Posen, 19 April 2012, justbanking.org.uk

Insufficient downsides

Overview

191. It is a source of great public bafflement and anger that so few individual bankers seem to have paid any personal price despite the widespread damage that has been caused by the various failures and scandals. In theory there is a wide range of sanctions that could be applied, including actions from within banks such as loss of job or clawback of pay, and official actions such as public censure, fines, industry-wide bans from serving as company directors and, in relation to certain offences, even jail. Official sanctions, impeded by the lack of individual accountability described earlier in this chapter, have been so rare as to be largely meaningless as a deterrent. The sanctioning of individuals has instead largely been left to weak and inconsistent internal mechanisms in banks.

Doing the decent thing

192. Although it is true that many bankers have lost their jobs since the financial crisis, most of them played little direct part in causing the problems. Some senior executives who were responsible for failures have been seen to resign as a direct consequence of those failures, while not acknowledging any personal fault. Earlier in this chapter we considered the accountability firewall at work regarding responsibility for LIBOR manipulation. Furthermore, many individuals who held senior positions in areas where failures occurred remain in post or in similar positions elsewhere in the financial system. For example, of the 18 executive and non-executive directors who were on the RBS board when it had to be rescued in 2008, 8 of them were still on the boards of financial services firms as of the end of 2011.⁴⁵²

193. It was only after the publication of our Report on the failure of HBOS that James Crosby left two senior roles: as non-executive director of Compass Group, the world's largest catering company, and an advisory role at private equity firm Bridgepoint.⁴⁵³ Lord Stevenson relinquished his last remunerated position in the financial services sector in the week he gave evidence to the Commission.⁴⁵⁴ As we noted in our report on HBOS, the FSA appeared to have taken no steps to establish whether these individuals are fit and proper persons to hold Approved Persons status.⁴⁵⁵ We understand that this work is now being undertaken as part of the regulators' forthcoming report on the HBOS failure.

194. Some bankers have faced financial losses as a result of the failures, through bonuses being cut or through the fall in the value of bonuses held as equity.⁴⁵⁶ However, such losses cannot be viewed as a meaningful sanction in most cases. Banking was a one-way bet, where participants had the chance to make large short-term gains by taking risks and

452 "Where are they now? What became of the 18 Royal Bank of Scotland directors who oversaw its demise?" *Scotland on Sunday*, 11 December 2011

453 "Ex-HBOS chief Sir James Crosby asks to return knighthood", *BBC News*, 9 April 2013, www.bbc.co.uk

454 B Ev 258

455 Fourth Report, para 135

456 "Lloyds bank claws back £1.5m bonuses from directors", *The Guardian*, 20 February 2012, www.guardian.co.uk

bending rules, but where if things went wrong the costs fell on others. As a result of the historic lack of deferral or clawback clauses in banker pay, many have been able to hold on to the vast rewards that accrued during the good times—whether deservedly or not—so even having gambled and lost they remain significantly in pocket. Fred Goodwin may have lost much of the value of any RBS shares he held, but over his eight years as CEO of the bank he earned a cumulative salary of £8.3 million and £12.4 million in bonuses (a large portion of which he would have received in cash, or shares which he later sold),⁴⁵⁷ and left with an annual pension worth £342,000, even after giving up a portion under public pressure.

Regulatory penalties on individuals

195. Regulators have the power to impose significant penalties on individuals who engage in inappropriate behaviour, unlike banks, who can generally only impose penalties if they are within the terms of their contracts with their employees. The prospect of public censure, significant fines or being banned from the industry could provide a meaningful downside to balance the significant upsides in banking. However, there has been negligible use of such sanctions against individuals.

196. In relation to the financial crisis, despite the ample evidence of widespread failures of management, leadership and risk control, the FSA has only brought a single case against an individual: the former head of Bank of Scotland's corporate division, Peter Cummings, who was fined £500,000 and given a lifetime ban from the industry.⁴⁵⁸ Our Fourth Report, on the failure of HBOS, concluded that:

downfall cannot be laid solely at the feet of Peter Cummings. While his personal responsibility for some staggering losses should properly be recognised, significant and indeed disastrous losses were also incurred by other divisions, whose heads have not been held personally accountable in the same way. [...] The Commission considers it a matter for profound regret that the regulatory structures at the time of the last crisis and its aftermath have shown themselves incapable of producing fitting sanctions for those most responsible in a manner which might serve as a suitable deterrent for the next crisis.⁴⁵⁹

The FSA intended to pursue an industry ban on Johnny Cameron, a former RBS executive, but ended their investigation in 2010 when he voluntarily agreed not to work in the financial services industry again.⁴⁶⁰ No other directors or senior executives from any UK banks which failed or needed public support have faced any regulatory sanction. The only other senior executive from a large UK bank to face any enforcement action in recent years was John Pottage, a former UBS wealth management executive, whose fine for misconduct was overturned by tribunal in 2012.⁴⁶¹

457 RBS Annual Reports, www.investors.rbs.com

458 Peter Cummings, FSA Final Notice, 12 September 2012

459 Fourth Report, para 134

460 "FSA Statement on Johnny Cameron", FSA Press Notice FSA/PN/081/2010, 18 May 2010, www.fsa.gov.uk

461 "Statement: Mr John Pottage", FSA statement, 23 April 2012, www.fsa.gov.uk

197. Investigation and potential enforcement action against individuals is still ongoing in relation to the manipulation of LIBOR,⁴⁶² but it seems likely that this will be restricted just to those individuals directly involved with falsifying the figures rather than extending to the more senior executives who had responsibility for the systems and controls which failed. As Tracey McDermott, the FSA's head of enforcement, told us:

What you do in an investigation is follow where the lines of inquiry take you. You do different investigations in different ways, but typically you will start working up from the bottom to get through the process, and see which direction you are pointed in, in terms of who are the people with responsibility and who are the people who are aware. You expect people who you are interviewing—if they think that it is not their fault, but that somebody more senior was actually responsible—to point you in that direction. The questions you ask are around where the trail takes you, and where this stops.⁴⁶³

In the case of UBS, this approach to investigations meant that the executives in charge of the investment bank at the time manipulation took place were not even interviewed by the supervisor and said they learned of the events only on reading about them in the press.⁴⁶⁴

198. Similarly, no members of senior management of a major bank has faced enforcement action over PPI mis-selling:

no senior management in financial services organisations had enforcement action taken against them for the mis-selling of PPI. The only senior management individual to have enforcement action taken against them for mis-selling unsecured loan PPI was the chief executive of a furniture retailer (Land of Leather). Not a single individual senior banking executive has ever had enforcement action taken against them for presiding over the mis-selling of products.⁴⁶⁵

Tracey McDermott clarified that “it is actually seven individuals in relation to PPI, but they are not [from] large banks”.⁴⁶⁶

199. Delegation and organisation distance acts to protect senior management from culpability for conduct failures within their chains of responsibility:

Decisions were made further down the chain of command. If the delegation was appropriate (i.e. to an appropriately qualified person with suitable resources etc) the more senior individual will not be at fault. In conduct cases (although perhaps less so in prudential matters) the decisions which are made which impact adversely on customers may sometimes be made a long way from the top of the organisation and the senior management and/or board currently have relatively little visibility of them.⁴⁶⁷

462 Q 2284

463 Q 2263

464 Q 2233

465 Ev 1463

466 Q 3002

467 Ev 1056

200. The virtual absence of official sanctions against individuals, despite the widespread failures, has contributed to a loss of public trust in banking which even the banks themselves acknowledge. HSBC told us:

Inability to pursue individuals for behaviours deemed wholly unacceptable by society but for which there are no sanctions available has contributed to deterioration in public trust in the industry.⁴⁶⁸

Virgin Money added that “The failure to take action against individuals adds to public concern that directors and senior executives of large banks seem to be “above the law”.⁴⁶⁹

Fines for firms

201. The largest fine imposed on a bank for mis-selling PPI was £7 million on Alliance and Leicester, a tiny proportion of the revenue they gained from selling this highly profitable product. Clive Briault, former Managing Director of Retail Markets at the FSA, told us that such fines were accepted as a cost of business:

I would certainly go along with a view that, purely as a matter of economics, if you compare the level of the fine against the big profitability of the business, you could chose to regard it as a cost of doing business, yes.⁴⁷⁰

Mr Briault went on to acknowledge that fines levied for PPI mis-selling were largely unrelated to the profits made from those sales:

it was not linked very closely to the amount of profit made through the particular activity. That was just as true in all other activities as for PPI. That was by no means unique to PPI.⁴⁷¹

202. The fines enforced by the FSA on Barclays, UBS and RBS are by some distance the largest in their history.⁴⁷² However, such punishments are unlikely to have any impact on individuals, who have little or no loyalty to the firm and are primarily motivated by short-term revenue generation. Michael Foot told us:

As far as the other group is concerned—those individuals who do not care in the sense that they put a higher priority on short-term success and are prepared to walk the line or run the risk of punishment—all I can say is that the regulator has very few carrots so the sticks have to be as large as possible. These people tend not to care about the size of the fine on the firm; they care only about fines on them and serious damage to their capacity to earn money and maintain their reputation going forward. That is where the thing will have to focus as best it can.⁴⁷³

468 Ev 1126

469 Ev 1438

470 JQ 191

471 JQ 193

472 Ev 1052

473 EQ 55

Conclusions

203. 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.

204. Many of the rewards have been for activities previously undertaken within a partnership model, a model under which a more appropriate balance between risk and reward exists. The return of these activities to partnership-based vehicles such as hedge funds could help redress the balance and is to be encouraged.

4 Tackling resistance to reform

Introduction

205. The previous chapter outlined the problems of the banking sector and suggested that many past problems are still present. Notwithstanding the depth and breadth of the problems, the case for further reforms to tackle them has not been universally recognised. This chapter considers some of the potential risks and obstacles which may be cited as arguments against further reforms, and explains why these should not be barriers to action.

It's all under control

The aims of current reforms

206. Anthony Browne often refers to the “almost [...] complete regime change” of 90 per cent turnover of bank board members over six years of turmoil since 2007.⁴⁷⁴ The new leaders of the largest banks have been vocal in disowning the previous regime, admitting mistakes and pledging a new approach. Sir David Walker talked about “putting in place a set of changes that would ensure all this was changed rapidly, but also fundamentally”,⁴⁷⁵ while Antony Jenkins said that he guaranteed that reforms he had put in place would deliver “progress over time”.⁴⁷⁶ Stephen Hester said “the mess that RBS represented is not yet cleared up and there are still some hard yards to travel, but I can give you my assurance that we are doing our best”.⁴⁷⁷ Stuart Gulliver, who Douglas Flint praised as “working tirelessly for two years [...] to repair that which is broken” spoke about having implemented the “biggest organisational change” in HSBC “since 1865”.⁴⁷⁸

207. Some witnesses told us that much of the required change had already occurred. Andrea Orcel said “I think we are very far ahead on the road of getting it done”.⁴⁷⁹ In a recent article, Anthony Browne wrote:

Those with a keen interest in seeing banks change—and that is most of us—have to acknowledge the amount of change that has actually happened, otherwise they will end up demanding change without end.⁴⁸⁰

Witnesses also pointed to the significant volume of regulatory reform which has taken place since the crisis, or is due to be implemented over coming years. HSBC told us that “The changes already in place and in contemplation are comprehensive and well designed to address many of the issues”.⁴⁸¹ London First argued that existing regulatory reforms

474 Anthony Browne, “A revolution in banking regulation”, *BBA Blog*, 4 April 2013, www.bba.org.uk

475 Q 3522

476 Q 3561

477 Q 4096

478 Qq 3776, 3778

479 Q 1817

480 Anthony Browne, “A revolution in banking regulation”, *BBA Blog*, 4 April 2013, www.bba.org.uk

481 Ev 1126

should be “given time to take effect and evaluated before any further measures are considered”.⁴⁸² The BBA stated that

the legislative and regulatory standards applying to UK banks [...] mean that the UK regulatory requirements are seen as matching those in existence in other developed economies. Further additional reforms are being undertaken at a UK level which we do not expect to be replicated elsewhere [...] and we therefore believe that the starting point for the adoption of new measures should be an appraisal of the application of existing mechanisms.⁴⁸³

The City of London Corporation made a similar point:

Inevitably, there will be political and media pressure for new, stronger and more prescriptive regulation of banking and financial services in general. This is understandable. But the regulatory framework has already changed radically over the last four years and the priority now should be on the effective enforcement of existing regulations, rather than adding new ones, with adequate resources for doing so.⁴⁸⁴

208. The effectiveness of existing or proposed reforms in specific areas will be considered throughout the rest of the Report. However, it is important to note that the primary purpose of many reforms to date has been to improve financial stability, rather than tackle directly problems with standards and culture in banking. For example, the purpose of the Financial Service Act 2012, which introduced the PRA and FCA, was to “to avoid a repeat of the financial crisis”.⁴⁸⁵ Sir David Walker’s 2009 review on corporate governance in banks was also focused on stability rather than standards, as he admitted:⁴⁸⁶

I didn't talk much about culture or reputation. Those are the issues that are of most prominent concern now. The reason that I didn't talk about reputation, culture and conduct at that time was because the biggest issue then was the survival of banks [...] attention is now focused on these other issues, which were overshadowed by the problem of financial stability.⁴⁸⁷

Similarly, the terms of reference of the Independent Commission on Banking were restricted to considering measures to “promote stability and competition”.⁴⁸⁸ Though it was acknowledged that their ring-fencing proposal could have positive cultural impacts,⁴⁸⁹ it would be remarkably serendipitous if a policy designed to promote financial stability and reduce systemic risk turned out also to be a panacea for standards and culture failings. Sir John Vickers told us that “standards and culture issues have emerged on both sides of the

482 Ev 1235

483 Ev 843

484 Ev 978

485 Financial Services Act 2012, Explanatory Notes

486 Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations*, 26 November 2009

487 Q 3

488 HM Treasury, *Independent Commission on Banking: Terms of Reference*, June 2010

489 Ev 914, 1216

fence”, and said he feared that scandals such as mis-selling could have happened even “in a totally separated world”.⁴⁹⁰

Financial stability: a work in progress

209. Reforms such as increased capital requirements, a dedicated prudential supervisor and the creation of the Financial Policy Committee, the implementation of ring-fencing and the introduction of a regime for bailing-in the debt of failed banks are all important and valuable steps towards improving financial stability and reducing the implicit guarantee. They are likely to have beneficial effects on the ability and incentives of banks to take excessive risks, which in turn should have beneficial effects on culture and standards. However, as set out in our First and Second Reports, there remain important concerns about whether existing reforms go far enough even on the specific issue of financial stability.

210. Barclays argued that measures implemented since the financial crisis meant that banks were now less likely to fail:

Significant reform has already been undertaken in this area: banks are considerably better capitalised; they hold much bigger, and higher quality, liquidity buffers; have reduced leverage ratios; supervision and prudential regulation is being strengthened (with the UK playing a lead role in international negotiations as well as through unilateral action); and the wholesale markets in which banks operate are becoming more transparent and better regulated. The result is that banks are much less likely to fail than they were pre-crisis. Further reforms are still in the process of being finalised and implemented that will make that likelihood even lower.⁴⁹¹

Many witnesses were also keen to point out that, as well as the risk of bank failure being reduced, significant progress is being made to reduce the likelihood that taxpayer funds would be required in the event of bank failure. The Chancellor of the Exchequer told us that the measures in the then draft Financial Services (Banking Reform) Bill will resolve issues of ‘too big to fail’:

The basic problem of “too big to fail” will be with us for a long time unless we address it, and I think that the Bill addresses it.⁴⁹²

RBS said “UK authorities will have the necessary tools and powers to carry out resolution while maintaining financial stability and minimising risk to public funds”,⁴⁹³ a view echoed by Barclays⁴⁹⁴ and Virgin Money.⁴⁹⁵ Asked what the consequences would be in the event of an imminent failure of their bank, the heads of Santander UK, HSBC and Barclays all

490 Q 760

491 Ev 799

492 Q 1059

493 FR Ev 109

494 Ev 798

495 FR Ev 152

suggested that recovery and resolution plans already existed which would not require the use of public money.⁴⁹⁶

211. Our First Report endorsed the Government’s aim of reaching a position in which any failing bank can be resolved without risk to financial stability or to public funds.⁴⁹⁷ In adopting several of the measures we recommended to strengthen the Bill, most notably “electrification” of the ring-fence, the Government has increased the prospect of success in this goal. However, the Government did not accept our recommendation on potential “electrification” with respect to the sector as a whole. As our First Report noted, crucial doubts remain about whether all the intended reforms can be put in place and, even if they are, whether this will be enough to prevent the Government from having to step in next time a crisis hits. In particular, we identified the possibility that the partial separation of a ring-fence may prove insufficient.⁴⁹⁸

212. The Government has already rejected some of the measures recommended in our First Report, including giving the FPC an immediate power to set a higher leverage ratio.⁴⁹⁹ Lord Turner warned:

I think we are still running the banking system on too high levels of leverage. I think we are the inheritors of a sort of 50-year giant mistake. Ideally, we would have much higher ratios.⁵⁰⁰

The major banks are still very highly leveraged and concerns about the adequacy of capital buffers remain. We examined these issues in detail in our First Report.⁵⁰¹ Chapter 9 considers them further.

213. Our First Report also expressed concern that great reliance is being placed on “bail-in” powers which would allow losses to be imposed on certain creditors of failing banks without taking them through insolvency.⁵⁰² The detail of how bail-in powers will work has yet to be finalised and put into law, and a number of witnesses warned that it could not yet be relied upon. Professor Rosa Lastra said “bail-in is a very useful instrument and the only problem with it is that it still needs to be tested. It needs to pass the market test of credibility and of not being stigmatised”.⁵⁰³ Jessica Ground expressed concern that bail-in “is one of those things that looks fantastic on paper”, but that, when it came to the choice of “pushing the button”, authorities might not be willing to take the risk of triggering a bail-in in a crisis because of the risk of contagion.⁵⁰⁴ Some witnesses warned of uncertainty about

496 Qq 539-540

497 First Report, para 104

498 *Ibid.* para 163

499 HM Treasury and Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, February 2013, Cm 8545, para 2.37

500 Q 4503

501 First Report, paras 280-296

502 *Ibid.* para 242

503 Q 705

504 Q 710

investor demand for debt that could easily be bailed in.⁵⁰⁵ In theory this should not be a concern, because making banks pay a higher price for bail-in debt would simply be a reflection of their true riskiness. However, in practice, there are doubts about the likely demand for bail-in debt. In our First Report, we stated that, to reduce contagion risk, banks should not hold it.⁵⁰⁶ It also remains unclear to what extent pension funds and insurance companies will be able to hold such instruments.⁵⁰⁷ As a result, bail-in debt could prove expensive to issue, which might result in regulators demanding too little of it. If this were the case, and losses exceeded the amount of bail-in debt available, authorities in future crises might face the difficult choice of whether to use taxpayer money or risk the economic and political consequences of imposing losses on more difficult classes of creditors such as depositors, as recently took place in Cyprus.

214. The political difficulties in the application of depositor preference as part of the resolution regime proposed in the Financial Services (Banking Reform) Bill were also examined in our First Report. We found the Treasury's case that all non-insured creditors, including charities and small businesses and households with temporary high deposits, would be treated alike in the event of failure, unconvincing.⁵⁰⁸ In their response to our First Report, the Government said that they acknowledged the "importance of examining the exceptional circumstances" where deposit insurance could be extended and would consider the issue further once the finalised Deposit Guarantee Scheme Directive was due to be implemented in the UK.⁵⁰⁹ Credibility in a resolution regime is a key determinant of the prospects for creditors exerting increased discipline on banks.

215. A number of witnesses, including several who were optimistic about the reforms in progress, acknowledged that the ability of UK authorities to resolve the UK's largest banks without recourse to taxpayer funds would still depend on cross-border cooperation.⁵¹⁰ HSBC said that "the tools are in place to handle a domestic failing bank but not yet in place globally for the failure of a large internationally active bank".⁵¹¹ Standard Chartered said that "it is not yet clear how [co-operation] will work across borders, especially beyond the EU".⁵¹² Sir Mervyn King said "we should not believe that we are anywhere near close enough yet to having an international resolution regime".⁵¹³

216. Asked how far the reforms in train went towards eliminating the implicit guarantee, Sir John Vickers held out hope of getting three quarters of the way there, but conceded that so far "we might be a quarter or a third along that path".⁵¹⁴ John Kay was more pessimistic,

505 FR Ev 16; Qq 564, 700

506 First Report, para 242

507 *Ibid.* para 240

508 *Ibid.* para 279

509 HM Treasury and Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, February 2013, Cm 8545, para 2.48

510 FR Ev 40, 82; Q 705.

511 FR Ev 138

512 FR Ev 152

513 Q 4505

514 Q 837

stating that he “would be slightly surprised if anyone really thought” planned reforms were sufficient to deal with the too-big-to-fail problem.⁵¹⁵ Even in relation to ring-fenced banks, Dorothy Livingston warned “I am not sure that we will be in a position to know that they can be resolved without recourse to public funds”.⁵¹⁶ Lord Turner warned that the guarantee will always be in place in some form:

The honest truth is that if you believe that you have forever completely destroyed the possibility of a taxpayer input, we’re probably fooling ourselves. But if we are successful, we will reduce the periodicity of a taxpayer input from once every 50 years to once every 200 years.⁵¹⁷

Virgin Money argued that even the most significant exception to governments opting to bail out systemic institutions, the bankruptcy of Lehman Brothers in September 2008, reinforced the impression that the guarantee remains:

For a large failing non-ring-fenced bank, the best answer might be to allow it to fail, through the resolution process [...] however, it remains to be seen whether the authorities, in the UK or elsewhere, will be willing to allow such an outcome, in what would probably be severely stressed conditions, given what followed the failure of Lehman Brothers in 2008.⁵¹⁸

217. Tony Greenham told us that the New Economics Foundation calculated the value of the subsidy across large UK banks to still be as large as £34 billion per year.⁵¹⁹ Andy Haldane has estimated that the implicit guarantee is now substantially larger than it was before the crisis. This, he has argued, reflects a more concentrated market. It also, he has contended, reflects the fact that the willingness of governments to intervene in the event of crisis has been demonstrated in practice:

Progress has been made over the past few years towards eliminating too-big-to-fail, with further progress on implementation planned. But today’s task is even more daunting than before the crisis. The big banks are even bigger. The system itself is more concentrated. And despite reform efforts, the market’s best guess today about tomorrow’s implicit subsidy is far-larger than before the crisis struck, at over \$300 billion per year. The market believes that implicit state promise is even more likely to be kept.⁵²⁰

The fact that large banks continue to exist, Haldane argued, is itself an indication that the implicit guarantee supporting them must be intact:

banks have chosen the size which maximises their private value. But implicit subsidies may have artificially boosted the privately-optimal bank size. Subtracting this subsidy, removing the state crutch, would suggest a dramatically lower socially-

515 Q 309

516 Q 703

517 Q 1005

518 FR Ev 152

519 Q 2984

520 Bank of England, *On being the right size*, Andy Haldane, 25 October 2012, www.bankofengland.co.uk

optimal banking scale. Like King Kong and Godzilla, these giants would arguably then be physiological impossibilities.⁵²¹

218. US regulators and politicians have recently expressed their concerns that existing reforms have not eliminated the implicit guarantee. The Senate voted 99-0 in support of a non-binding resolution to end too-big-to-fail, put forward by Senators Sherrod Brown and David Vitter. Those senators subsequently introduced a bill called the “Terminating Bailouts for Taxpayer Fairness (TBTF) Act” which includes proposals to increase capital requirements for large banks significantly above the Basel III level.⁵²² Senator Bernie Sanders and Rep. Brad Sherman introduced another recent bill also aimed at breaking up banks which were too big to fail.⁵²³ These actions come in response to sustained public criticism in the US of the inadequacy of the Dodd Frank Act in tackling the too-big-to-fail problem, such as the statement by the President of the Federal Reserve Bank of Philadelphia that “Ending too big to fail was one of the highest priorities of regulatory reform and one of the most difficult to achieve [...] I think current efforts may not be sufficient”.⁵²⁴

219. The Commission has been told that failures in banking standards were the product of a system which is already being replaced, and that current reforms will largely suffice. Bank leaders argue that they are well on the way to completing the correction of the mistakes that were made. Numerous regulatory reforms will supposedly ensure that such mistakes will not, in any case, be allowed in future. Significant progress has indeed already been made. However, the Commission has concluded that reliance solely on existing reforms and on the good intentions of those currently in charge of banks will not be enough.

220. The majority of post-crisis regulatory reforms are aimed at improving financial stability and removing the implicit government guarantee. This can make an important contribution to banking standards. However, many of these reforms have yet to be introduced or take full effect, and there is convincing evidence that they will not be taken to the point where the implicit taxpayer guarantee is eliminated. The efficacy of such reforms will remain untested until the next crisis. In any case, measures aimed at improving financial stability will not remedy other underlying causes of poor standards and culture.

Risks to the competitiveness of the UK banking sector

Overview

221. The Commission has been warned that over-zealous action to improve banking standards would damage the competitiveness of British banks and of the UK as a financial

521 *Ibid.*

522 “Can two senators end ‘too big to fail?’” *Washington Post*, 10 May 2013

523 “Sanders, Sherman propose legislation to break up big banks”, press release by Senator Sander, 9 April 2013

524 Charles Plosser, Federal Reserve Bank of Philadelphia, *Can we end too big to fail?* 9 May 2013; “The drumbeat over too-big-to-fail banks continues with Hoenig speech”, *Wall Street Journal*, 9 April 2013

centre, resulting in banks, bankers and banking activity moving abroad or into shadow banking. London First argued that measures which reduce London's attractiveness to banks could result in wider damage to the economy:

A key factor in London's global city status is its leading financial services sector. A diminution of this would threaten London's global status which, in turn, would have a wider impact on the London economy. For example, London's leisure industry is reliant in part on serving high-earning individuals, many of which are employees of the financial and professional services firms. If domestic demand is reduced this could, in turn, lead to a reduction in facilities which in turn would reduce the attractiveness of London to tourists and, indeed, to other businesses.

222. There is no doubt that there is a balance to be found in reform. This is the essence of what the Chancellor of the Exchequer was referring to when he described the "British dilemma":

As a global financial centre that generates hundreds of thousands of jobs, a successful banking and financial services industry is clearly in our national economic interests.

But we cannot afford to let it pose a risk to the stability and prosperity of the nation's entire economy.

We should strive for global success in financial services, but that success should not come at an unacceptably high price.

We should be clear that we want Britain to be the home of some of the world's leading banks, but those banks cannot be underwritten by the British taxpayer.⁵²⁵

223. TheCityUK noted the importance of high standards to the UK's banking sector, "because of the impact a reputation for honesty and fair dealing has on the standing of the sector in overseas markets".⁵²⁶ This was also acknowledged by Anthony Browne, Chief Executive of the British Bankers' Association, in evidence to the Commission:

We want standards in the industry to rise. We want London to get back to the position of having such a high standards that they are gold standards for the rest of the world, so that people look to London and say, "Those are the sort of standards we should be following." We want to help the industry to get there. My members want that as well, because it is a competitive advantage.⁵²⁷

224. 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

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

526 Ev 1364

527 Q 2540

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.

International competitiveness

Effects on British banks

225. Any measures which the UK takes in addition to those agreed at the European or international level have the potential to affect the relative competitiveness of British banks. There are three main channels through which it is argued this could pose a problem. First, as a consequence of the European single market, it is possible for banks headquartered elsewhere in Europe to “passport” into the UK and operate here via a branch without having to establish a separate subsidiary that would be subject to the full range of UK regulations.⁵²⁸ To the extent that the UK imposes more onerous or costly requirements on UK-based banks than banks which passport in, this mechanism could therefore give a competitive advantage to non-UK firms wishing to operate in the UK. António Horta-Osório warned:

you have to be mindful of a level playing field. For example, to allow different rules for capital, and then to allow through the European passport European banks to come to the UK or European insurers to come to the UK and offer better products because they have less capital requirements would not be in the UK’s interest.⁵²⁹

Second, several large UK-based banks have significant wholesale market activities and operate in global capital markets, competing directly against firms based in other jurisdictions for internationally-mobile business. Tougher regulation which increases their costs could again have the potential to damage their international competitiveness. For example, in relation to the impact of the ring-fence, HSBC argued:

Concerns around international competitiveness relate primarily to the non-ring fenced banks or “wholesale banks” which will result from ring-fencing. In providing services to the international corporate operating both in the UK and other jurisdictions, these banks will continue to compete with other wholesale banks aiming to serve the same customer base, most of whom will not be subject to the UK’s ring-fence requirements. [...] UK wholesale banks will operate with a number of disadvantages compared to their foreign rivals.⁵³⁰

Sir John Vickers noted that one of the benefits of a ring-fence was that it addressed this concern in relation to higher capital requirements, by allowing them to be imposed only on the UK-based part of a bank:

528 Bank of England, Prudential Regulation Authority, *Passporting FAQs*, www.bankofengland.co.uk

529 Q 3495

530 Ev 874

One virtue of the ring fence, although not the primary one, is that you can have high capital buffers there while international business carries on being conducted according to international standards.⁵³¹

226. Third, some UK-based banks, most notably HSBC, Standard Chartered and Barclays, have significant retail and commercial operations in foreign countries. If their operations in such countries had to meet tough UK standards, they might find it harder to compete with local rivals or firms from other countries who are only bound by internationally-agreed standards. It was in part in response to this concern that the Government proposed the possibility of overseas operations having an exemption from the higher loss-absorbing capital requirements recommended by the ICB, a measure considered in our First Report.⁵³²

Banks may leave

227. Some witnesses argued that, if moves toward a stronger regulatory environment in the UK resulted in an uneven playing field as described above, this could result in banking activity being shifted out of the UK, or even in UK banks moving their headquarters. The City's competitiveness and economic contribution, dependent on a critical mass and mix of firms in one location, could therefore be significantly undermined. The argument follows from the premise that banks are able to pick and choose the country in which they are regulated, and (separately) the country in which they conduct their activities, to attain a profit-maximising mix of regulatory and operational environments.

228. In markets where UK banks burdened with heavier regulation were competing directly with foreign rivals, they could risk losing business to them over time, along with UK-based jobs and revenue. HSBC, in its response to the ICB's Interim Report, warned of this in relation to the ICB's ring-fencing and capital proposals:

There is no doubt that UK banks would be competitively disadvantaged. [...] domestic providers of wholesale / investment banking services will diminish—rational investors will not knowingly accept lower returns for a similar level of risk. Corporates and staff will also migrate given the clear trends in financial flows and the administrative costs and distraction in institutions facing break-up. There can be no doubt that creating a playing field which is tilted against UK banks will have implications for the wider UK economy:

(i) The UK banking sector would diminish with consequences for employment, tax receipts and ultimately GDP growth.

(ii) The industry would be dominated by international players with potentially lower capital requirements making capital flight and credit withdrawal a greater risk in times of synchronised economic stress

229. This kind of effect could result in pressure for some UK banks to re-domicile their headquarters so that they could avoid the regulatory implications of being headquartered

531 Q 784

532 First Report, para 250

here. A bank could in theory move its headquarters while keeping substantial operations in the UK—many international banks such as the US, German or French universal banks already operate in this way—but moving headquarters might nevertheless be expected to result in the loss of some key jobs, a loss of regulatory control over systemically important activities and a fall in tax revenues.

230. Alternatively, a UK bank might relocate some of its operations by routing more business through a branch or subsidiary in another country. This would not allow banks to evade UK regulations which were imposed on a group-wide basis, but could allow them to take advantage, for example, of differences in personal tax regimes or remuneration limits when choosing where to locate highly-paid activities.

231. Changes to the regulatory environment might also cause overseas banks to relocate some of their operational activity away from the UK. There are recent precedents of this occurring: it was reported in late 2012 that several Chinese banks had begun to route more business through Luxembourg, rather than UK, following a refusal by the FSA to allow them to set up branches in London.⁵³³ Finally, the establishment of new financial services activities in the UK could be discouraged if firms deciding where to base themselves or where to expand their operations perceive the UK as a costly and burdensome place to do business. This would not necessarily be limited to consideration of the financial regulatory regime; decisions on where to invest and locate activity are as likely to be based on factors such as the taxation regime, employment costs and regulation, and general perceptions about levels of “red tape”.

232. 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 attractions of the UK

233. In assessing the likelihood of the UK losing banking activity, it is important to consider the factors, aside from regulation, that contribute to the City’s pre-eminence as a global financial centre, and make it a highly internationally competitive place to conduct banking business. These were summarised by JPMorgan in written evidence:

London’s stable regulatory, fiscal and political environments have always been important factors in attracting international financial businesses. The robustness, independence and commercial focus of the English legal system and the rule of law; the proximity of other related business services such as accountants, auditors and consultants; the English language; time-zone and geographic location in between the East and West; availability of talented employees have all been key factors in this attraction.⁵³⁴

⁵³³ “Chinese banks flee London’s tough rules”, *The Financial Times*, 28 October 2012

Some of these factors, such as the UK's institutional environment, are difficult for many countries to replicate. Others, such as time zone and language, are virtually impossible. Michael Cohrs believed these innate advantages to be particularly important in keeping banks in the UK:

No other location has Greenwich Mean Time. Don't underestimate how important that is to the way a bank operates. A lot of it is automated, but a lot of it is not; it is people talking to each other, and time zone is really important.⁵³⁵

234. There is evidence to suggest that this balance of factors continues to favour the City. In the most recent Global Financial Centres Index, London was placed top for the sixth year running and increased its lead over second-placed New York, although several Asian financial centres continued to close the gap on these leaders.⁵³⁶ Paul Volcker stressed to us that only New York was comparable to London as a financial centre:

The argument that you hear all the time is, "Oh, we are all going to move to New York." If you are in New York, you hear, "Oh no, we are all going to move to London." Those are the only two centres now that really have the capability, the size and the knowledge really to do this in a big way.⁵³⁷

235. However, even London and New York are not simply interchangeable. Goldman Sachs explained that having access, via London, to markets across Europe without having to be physically located in them, as a result of EU 'passport' provisions, was a key consideration in determining where much of their business was conducted:

New York and London are preeminent financial centres because they sit within two of the largest financial markets in the world, the United States and Europe [...] the location of our clients and regulatory limitations on US firms accessing European markets and vice versa will typically dictate whether we do business from New York or London; we often do not have a choice between the two.⁵³⁸

In written responses to questions about their reasons for doing business in London, JPMorgan and Goldman Sachs did not express any concerns that the current regulatory agenda would influence the scale of their London-based operations.⁵³⁹ Bill Winters argued that the core elements of the UK prudential regulatory reform did not significantly affect overseas firms, or alter the balance in favour of other countries:

When I look at the various pieces of legislation working their way through the process, as well as the recommendations from the Independent Commission on Banking, on which I sat, they are all targeted at supporting and protecting the UK economy, the UK consumer and the UK sovereign from the excesses of any aspect of the banking market, be it onshore or offshore. For a pure offshore player operating in

535 EQ 35

536 Global Financial Centres Index 2013, www.zyen.com

537 EQ 96

538 Ev 1091

539 Ev 1091,1569

the UK, who has never relied on support from the Government in any way, there should be absolutely no effect.⁵⁴⁰

236. The growth of the UK as an international financial centre from the 1970s onwards was only in part the result of the UK's own policies. Factors such as overseas regulatory restrictions drove the growth of “Euromarkets” in foreign currencies in London, and, following the removal of capital controls, the City was uniquely well-placed to benefit from subsequent globalisation of financial trade and financial markets.⁵⁴¹ However, as the ICB Interim Report noted, while the City benefited as a whole, UK banks themselves were not the key players:

the leading banks in London in 2000 were American, European and Japanese. They had been better placed – culturally, financially and operationally – to exploit the opportunities of the Big Bang, and in doing so pushed London further towards its place at the centre of the global financial system.

Just as global conditions gave rise to the current composition of the City, these may already be changing. HSBC identified an “increasing trend towards geographic subsidiarisation” subsequent to the crisis,⁵⁴² which may undermine the global banking model underpinning much of London's activity. The continuing rise of Asian economies may also see a gradual shift in activity towards financial centres located in these markets.

237. 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.

Constraints on re-domiciling

238. A UK bank seeking to re-domicile would face several constraints. The most obvious of these is the practical difficulty and associated expense of changing the legal jurisdiction of such large, complex institutions, as noted by Michael Cohrs in recollecting his experience at Deutsche Bank:

You may remember that, about a decade ago in Europe, the concept of being a European corporation was introduced [...] We looked at that because it was modern and there may have been some benefits. In the case of Deutsche Bank [...] just the complexity and, to be very blunt, the tax bill of leaving the country made the whole concept a non-starter [...] generally speaking, it is really hard—just as it is really hard to separate a bank—for a bank to move its jurisdiction.⁵⁴³

A UK bank that re-domiciled within the EEA could operate branches in the UK under ‘passporting’ provisions without having to comply with UK prudential requirements,

540 Q 3671

541 Roberts & Kynaston, *City State: a Contemporary History of the City of London and How Money Triumphed*, 2002

542 TR Ev 14

543 EQ 34

although branches remain subject to some domestic regulations, for example on conduct and liquidity. Andrew Bailey believed that the ‘right’ of an EEA bank to branch in to the UK should be circumscribed where the PRA had concerns about its resolvability:

At the moment, frankly, banks can branch into this country and there is not much we can do about it. A minimum condition for me, if there is a Liikanen implementation, would be that the host authority would be able to say, "No, I am sorry, I am not prepared to have this branch operating here unless you convince me that there is a resolution plan."⁵⁴⁴

If a UK bank re-domiciled outside the EEA, it would be required to establish either a European subsidiary or a UK subsidiary to continue conducting retail business in the UK. A UK subsidiary would be regulated by the PRA and be subject to local capital requirements, thereby limiting the regulatory benefits of re-domiciling.

239. There would also be political and reputational risks to re-domiciling for certain UK banks. Barclays and RBS have a long association with Britain, stretching a combined 600 years, that forms a strong element of their brand. HSBC, which moved its headquarters to London from Hong Kong in 1993, is arguably the UK’s most potentially footloose major bank, along with Standard Chartered, which has few UK-facing activities. HSBC has in the past conducted triennial reviews of the location of its headquarters. Before the 2006 review, HSBC’s then head of financial planning, Chris Spooner, told the *Evening Standard* “we know how to move. We are not frightened of moving [...] HSBC pays a large amount of tax and we are the ones who decides who gets it”.⁵⁴⁵ In evidence to the Commission in November 2012, Douglas Flint said that the next decision had been postponed until 2015.⁵⁴⁶ Mr Flint explained:

We are in London because it is the best place to headquarter an international group today, and we will continue to be headquartered where it is the best place to have an international group.⁵⁴⁷

It has since been reported that the triennial review has been “postponed indefinitely”.⁵⁴⁸

Regulatory arbitrage

240. We received considerable evidence that causes of a regulatory move to the bottom may have been overstated, and that relocation between jurisdictions is to be expected as part of the globalisation of financial markets. While in theory some jurisdictions might seek to position themselves as offering a lower regulatory burden in order to attract banks, we were told that there were good practical reasons to doubt that this would occur in practice. Michael Cohrs was not concerned about the prospect of a major bank re-domiciling:

544 Q 1016

545 “HSBC ponders HQ move from Britain as tax regime bites”, *Evening Standard*, 6 October 2006

546 Q 577

547 Q 574

548 “HSBC puts back thoughts of HK move”, *The Financial Times*, 4 March 2013

I am dismissive of bankers when they tell me—I used to be one of them—‘If you don't give us a good regime, we will go elsewhere.’ It is rubbish.⁵⁴⁹

When rumours began circulating about the possibility of HSBC re-domiciling to Hong Kong, Martin Wheatley, then the chief executive of the Hong Kong regulator, the Securities and Futures Commission, questioned the wisdom of a small country accepting such a large bank:

You're right to ask if Hong Kong would want it. The question is, do you want to have something that big on your doorstep? For a place with a relatively small GDP compared to the size of HSBC, you have to ask if you want to have that risk in your system.⁵⁵⁰

The UK is carrying out regulatory reforms in part because the risks associated with hosting our largest banks in their current form are too big even for our economy. It is therefore questionable who else would be both willing and able to take on such risks without taking similar precautions. Bill Winters said that banks would face reputational risks in being seen to seek out a jurisdiction with laxer standards:

the attraction to an HSBC of Singapore would have to be some combination of group-level regulation, taxation, some other cost of doing business, or an image that they would be creating in the minds of their customers and employees of being, in your example, a Singapore bank rather than a UK-based bank. I think it is pretty hard for a country like Singapore, or any other country on earth, to offer those kinds of advantages, because as soon as Singapore says, ‘The FSA is being super-equivalent, the PRA is being super-equivalent in terms of liquidity requirements, so we are going to be a little bit more relaxed so that we can bring HSBC into our economic zone,’ that would be the last thing in the world that HSBC would want to endorse.⁵⁵¹

New businesses

241. The risk of regulatory arbitrage would perhaps be greater in the case of banks deciding where to base new investments or activities, rather than a full relocation of their headquarters. If the UK were to adopt significantly more costly regulations than other countries this could indeed be a factor, but it is important to recall that UK regulatory reforms are not happening in isolation. Antony Jenkins said “there are concerns that if we create a banking system that is too highly regulated, that could cause London to lose business over time; but, as we know, other parts of the world are also engaged on their own regulatory activities”.⁵⁵² Martin Wheatley noted the lack of appetite among national regulators to compete on lower standards to attract business:

549 EQ 34

550 “HSBC too risky for Hong Kong”, *City AM*, 11 May 2011

551 Q 3706

552 Q 568

It's not in anyone's interests to create lower standards and regulatory arbitrage. The spotlight would immediately be on the regulator that does that.⁵⁵³

Martin Taylor also told us that the similar paths of regulation across financial centres meant that the threat of redomiciling in search of lax regimes had subsided:

I do not believe that we will have wholesale moving of banks' head offices, which is what we were worried about two or three years ago, simply because pretty much the entire world is going in the same direction.⁵⁵⁴

242. While wholesale market activities might be globally mobile, the vast majority of jobs in banking in the UK relate to domestic retail and commercial activity. The ICB interim report's central estimate was that only 14 to 16 per cent of the City's activity was related to wholesale financial services.⁵⁵⁵ Domestic banking is largely insulated from considerations of international competitiveness, because all banks operating in the UK market have to play by a similar set of rules. While EEA banks can "passport" in without being subject to the UK's rules on capital, if any want to operate a retail branch network in the UK they would nevertheless be bound by many of the other regulations, including conduct rules.⁵⁵⁶ Lord Turner also told us that there were limits to how well a foreign bank could compete for UK business without effectively becoming a UK bank:

I think, realistically, the vast majority of SMEs or households will want to deal either with a domestic bank or with a bank, such as Santander, which has made such a commitment to this domestic operation⁵⁵⁷

Although reforms which affect domestic banking will not therefore carry a "flight" risk, any burdens that they impose could nevertheless result in the restriction of provision or higher costs for services to domestic customers.

Seeking higher standards

243. The UK banking sector's size and importance mean that there may be cases when it is in the UK's interests to exceed minimum international standards, even if that does have some impact on competitiveness. Sir Mervyn King drew on lessons from other countries which had made this choice:

Where your banking system is very large—as in the case of both Switzerland and, to some extent, Sweden—they decided that it was in their national self-interest to have a tougher leverage ratio than the Basel minimum because it reduced the risk to taxpayers in those countries. That is a decision that we ought to be free to take.⁵⁵⁸

553 "HSBC too risky for Hong Kong", *City AM*, 11 May 2011

554 Q 393

555 Independent Commission on Banking, Interim Report, April 2011, p 108

556 PRA and FCA Handbook, COBS 1 Application, www.fshandbook.info

557 Q 1016

558 Q 1210

The ICB, in its final report, argued that, if reforms aimed at ending the implicit guarantee drove some unsustainable banking activity out of the UK, that might be no bad thing:

some affected UK banks lose business to other banks, this does not constitute a coherent reason to maintain that subsidy in the UK, even if some foreign banks continue to enjoy an implicit state guarantee. The UK does not subsidise other industries in this way and there seems no reason to do so for wholesale/investment banks, particularly given the damaging incentives that these guarantees create.⁵⁵⁹

244. In the case of Switzerland, authorities there took the view following the crisis that their national interest was not served by continuing to underwrite large, international universal banks, despite the jobs and income they generated in good times. In part as a result of their reforms, their largest banks have significantly scaled back their investment banking activity. UBS executives told us that they were going to “bring the investment bank down again so that its risk-weighted assets will be much lower” in order to anchor the bank “around the wealth management and the retail and corporate business”.⁵⁶⁰

245. There is also a strong case that, rather than their being a trade-off between safety and competitiveness, there could in fact be a “race to the top” in regulation, where stronger and more stable jurisdictions which offer high quality regulation and supervision are more attractive to both investors and customers. On the prudential side, Dr Thomas Huertas has contended that high quality regulation should reduce risk to creditors and therefore be associated with lower costs of funding.⁵⁶¹ This argument implies that, in some instances, ‘super-equivalence’ and ‘front-running’ can become the friend, rather than the enemy, of international competitiveness and attract business, although this remains contingent on a regime that allows banks to be resolved and losses imposed on uninsured creditors. Sir John Vickers agreed that the City’s future status as an international financial centre relied on a strong regulatory regime:

One of the wider points we made about the competitiveness of UK financial services, and the City of London in particular—which includes a lot more than the banks, there is a whole array of things—is that in the long run, competitiveness is going to be favoured by a safer, sounder, more stable domestic banking structure, rather than by a riskier one.⁵⁶²

246. The case for a race to the top need not be limited to just capital strength. Anthony Browne agreed that higher conduct standards could also bring competitive advantages to the UK:

One of the clear underlying causes of many of the crises or many of the scandals in the banking industry has been a lapse in professional ethical standards [...] and that lapse of standards has been damaging to the international reputation of London, and one of the things we should try and do collectively as a country, and we will try and

559 Independent Commission on Banking, Final Report, September 2011, p145

560 Q 1880

561 Thomas F. Huertas, *A Race to the Top?*, LSE Financial Markets Group Paper Series, Special Paper 208, April 2012

562 Q 2576

play our part, is to make the UK a world leader in standards in banking [...] Historically, that has been London's advantage, and we need to restore it to that.⁵⁶³

247. 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.

European obstacles

248. It is widely accepted that the cross-border nature of financial services, and the scope for regulatory arbitrage described above, mean that national governments will often seek to pursue bilateral, regional or global agreements rather than acting alone. Where this results in effectively-designed and widely-implemented rules, this approach has benefits. However, design by international committee does not always make for the best rules, and committing to a common approach can constrain the UK's ability to take swift, decisive and targeted action. This is particularly important given the UK's unique circumstances as a medium-sized economy hosting one of the world's most important financial centres.

249. In particular, the UK faces important challenges in designing appropriate financial regulation as a result of the European Union's increasingly active approach in this area. The UK is disproportionately affected by many of the emerging rules, but is only one of the soon-to-be 28 members involved in negotiating them.

250. One of the most serious challenges arising from European legislation is that it may constrain the UK's ability to take unilateral action. For example, the European Commission's original proposal for implementing Basel III rules would have involved a high degree of maximum harmonisation, limiting the UK's scope to go further. The Financial Secretary to the Treasury recently wrote to the House of Commons European Scrutiny Committee confirming that this problem had been addressed in the latest draft:

the Commission's original proposals for CRR/CRD 4 were maximum harmonised, meaning the UK would have been unable to implement the recommendations of the Independent Commission on Banking (ICB) or give the Financial Policy Committee (FPC) the tools to conduct macro-prudential policy.

However, the UK was successful in ensuring that the final agreement allows the UK scope to apply a 3 per cent Common Equity Tier (CET) 1 buffer to the ring fenced part of a bank with no control by any EU institution.

The agreement also enables macro-prudential authorities to use a wide number of tools to address financial stability risks. In order to implement an extra prudential

measure, the FPC must submit relevant quantitative and qualitative evidence justifying its decision to the Commission⁵⁶⁴

251. In evidence to the Treasury Committee, Andrew Bailey identified an even more serious problem, saying that European regulation was the biggest obstacle to the PRA succeeding in its overall judgement-based approach:

The main challenge to judgement in my view comes from an approach in Europe which seeks to use detailed rules and so-called maximum harmonisation to create consistency in supervision. I do not think this will work as intended as an approach, and I hope that we can persuade the European institutions that their best interest lies in having strong supervisory institutions that can apply judgement sensibly.⁵⁶⁵

252. The EU's approach to financial regulation risks replicating many of the flaws discussed in Chapter 3, of being over-complex, rules-based and prescriptive. Being bound by such an approach may limit the UK regulator's ability to move to a more judgement-based system. The level of detail in EU rules may be a consequence of seeking to establish their even application across multiple jurisdictions. Andrew Bailey told the Treasury Committee:

Failures of past supervisory judgement have led to a pressure for more rules in the European Union, as has the pressure to preserve the Single Market. I strongly support the free trade underpinning of the Single Market, but I do not see ever more detailed rule-making as a sustainable solution to the identified problems, and nor is it necessary to achieve the free trade objectives of the Single Market.⁵⁶⁶

The PRA warned:

The EU processes have moved in the direction of using more detailed rule-making [...] it tends to be a self-reinforcing process as detailed rules which apply to 27 countries tend to require more detailed rules to deal with the inevitable exceptions to reflect national circumstances. With such a detailed body of rules comes, a much larger overhead of monitoring and compliance in regulatory bodies and firms. Moreover, more rules tend to encourage more effort and cost to "interpret" and apply them. In my view, there is no meaningful process of cost and benefit assessment which has a real impact on whether to adopt such rules.⁵⁶⁷

253. The process for developing detailed rules, which is largely delegated to the European Commission and the European Supervisory Bodies, can be opaque and unaccountable. Twelve Member States were reported to have recently signed a letter criticising the process for developing the delegated regulations relating to the Alternative Investment Fund Managers Directive, which they said:

564 Letter from Greg Clark to the Chair of the European Scrutiny Committee, 17 April 2013, www.parliament.uk/escom

565 Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 4

566 *Ibid.* p 12

567 Ev 1607

departs from ESMA's advice in a number of areas, without explanation. [...] The draft Delegated Act for the AIFMD Regulation is extremely large and has an extensive effect on the transposition of the Level 1 Directive. The scope of national discretion is widely limited. [...] this large opaque piece of the AIFMD regulatory package sets enormous challenge to the hearings of stakeholders and the national parliamentary process.⁵⁶⁸

254. Regulators and others have also complained that the EU approach risks leading to over-collection of financial data. As Andrew Bailey has explained:

the history and legacy of the FSA indicates the need to improve the approach towards requesting and processing data [...]. One important fly in the ointment on this front is the impact of the enhanced European data reporting standards. We have assessed that in some areas these requirements could lead to an increase in data submitted by firms by up to ten times the current amount. Some of these extra data may turn out to be of use to the PRA, but I cannot believe that such a large increase could be justified on the basis of needs.⁵⁶⁹

On this Sir Mervyn King has said that the PRA should “collect and process data only where the supervisors have a need to know”.⁵⁷⁰ Similarly, Douglas Flint told the Commission:

There is still a lower level of information-gathering to inform a regulatory supervisory system that is still commanding, partly for their own purposes and partly because the European Banking Authority [EBA] requires it. I think we will give six times more information to our regulators under the EBA rules than we do even under FSA rules.⁵⁷¹

255. 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.

Shadow banking

256. It has been argued that increased regulation of banks could lead to some activities previously carried out by banks moving outside the closely regulated system into “shadow

568 “UK leads 12-state rebellion against EC hedge fund rules”, *The Telegraph*, 17 February 2013

569 Written evidence from Andrew Bailey to the Treasury Committee, March 2013, pp 10-11

570 Speech by Sir Mervyn King at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 15 June 2011

571 Q 3848

banks” such as hedge funds and money market funds. Michael Foot said that this has been a common and influential refrain among banks arguing for more permissive liquidity requirements over the years:

this debate about what constituted an adequate level of liquidity was a global one and had been going on for 30 years. What every bank— whether it was J. P. Morgan, Deutsche, Barclays or whoever—was saying to their home regulators was, “We now have vastly improved systems for monitoring and reacting to financial pressures, and vastly new and improved ways of tapping money when we need it, but”—this was the key part—“if you don't give us further concessions, the shadow banking sector will take even more of our business than it is already doing. You wouldn't want that, would you?” That [...] was a point made by virtually every major bank that I can think of all the way through this period. If you want to find a reason why we went from 30 per cent down to something like 4 per cent, that is the biggest single one I would cite.⁵⁷²

257. An activity moving from a bank to a non-bank does not necessarily represent a loss for the UK as a whole, because the activity can continue and may even flourish outside banks—as evidenced by London's large population of hedge funds. The key question is therefore not one of competitiveness but whether the movement of banking activities to less intensely regulated entities poses a threat. If it does, there is a further question of whether it would be better to avoid this threat by refraining from regulating banks, or deal with it by tackling the risks in shadow banking.

258. Certain parts of shadow banking are thought to have played a role in the financial crisis. The US Financial Crisis Inquiry Commission concluded that

over the past 30-plus years, we permitted the growth of a shadow banking system— opaque and laden with short-term debt—that rivaled the size of the traditional banking system. Key components of the market—for example, the multitrillion-dollar repo lending market, off-balance-sheet entities, and the use of over-the-counter derivatives—were hidden from view, without the protections we had constructed to prevent financial meltdowns⁵⁷³

The run on money market mutual funds, and the sudden illiquidity of large broker-dealers in London and New York immediately after the collapse of Lehman Brothers in September 2008, played a key role in turning the crisis in the US mortgage market into an international financial crisis.⁵⁷⁴

259. The size of the shadow banking sector is not simply determined by the burden of banking regulation. It grew particularly rapidly between 2002 and 2007, even as operational restrictions on banking activity became generally more relaxed.⁵⁷⁵ Despite the speed of their growth, hedge funds performed relatively well during the financial crisis. Michael

572 BQ 1075

573 Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, January 2011

574 W.A. Allen, *International Liquidity and the Financial Crisis*, Cambridge University Press, 2013.

575 “Shadow banking surpasses pre-crisis level”, *The Financial Times*, 27 October 2011, www.ft.com

Cohrs noted “many smart people thought that the hedge funds would all go pop during the financial crisis. They largely didn’t”.⁵⁷⁶ This may be attributable to differing ownership structures. Paul Volcker pointed to the partnership model prevalent in hedge funds which meant that those running firms had “money [...] at stake”.⁵⁷⁷ Michael Cohrs argued that a movement of activity from large banks to smaller shadow banking institutions might in fact be desirable in reducing systemic risk:

I wish we had more of that because it would achieve my goal of making the big places smaller. I accept that shadow banking is an issue, and we do worry about it, but I am more worried about how large the largest banks are. To the extent that they hive off some of their activity and send it into shadow banking, the next generation of people who will do what I do can worry about that. In the meantime, I lie awake a lot more at night worrying about how big the big banks are.⁵⁷⁸

260. The risks attached to the growth of shadow banking have to some extent already been recognised, with work underway to address them. It therefore seems unlikely that migration of activity from banks to shadow banking would result in it fully escaping regulatory attention. The G20, via the Financial Stability Board, has developed a global framework to strengthen oversight and regulation of shadow banking.⁵⁷⁹ Paul Tucker noted the importance of measures to constrain the operation of the shadow banking:

All the things we are doing about banks in this country will leave a regime that is not fit for purpose unless, in parallel, we tackle malign forms of shadow banking. That does not mean that the re-regulation of banking itself is a mistake: on the contrary, but we would make a great mistake if we were blind to the inevitability, almost, of regulatory arbitrage and it just being cheaper to do certain kinds of financial intermediation outside of banks.⁵⁸⁰

261. 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.

576 EQ 31

577 Q 70

578 EQ 31

579 Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking Entities*, November 2012

580 Q 1207

Biting the hand that feeds us

Capital and lending

262. One reason why the regulatory burden on the UK banking sector and their cost of doing business matters is that banks' profitability, and hence their ability to attract new capital, affects their ability to expand their activity and lend to the UK economy. The ABI stated:

A robust banking return on equity is beneficial for the wider economy and not just equity shareholders. A robust ROE boosts internal capital generation, which in turn supports additional loan capacity, augments core tier 1 capital, i.e. loss absorbing capacity, and creates dividend distribution capacity. [...] failure to achieve at least cost of capital across the cycle is likely to lead to banks' businesses being unsustainable in the longer term and will inevitably constrain asset growth and lending to the wider economy.

263. The attractiveness of the banking sector to investment may be thought to be particularly important in an environment where banks need to raise capital in order to meet higher capital requirements. If investment prospects are poor, and investors demand a high price for new equity, bank management and existing shareholders may be more inclined to meet higher capital ratios by deleveraging their balance sheet. It is the fear that banks will respond to higher capital requirements in this way which led *The Times* to comment after the recent FPC announcement that “every pound of extra capital the banks are told to raise is a pound less to be lent to small business”.⁵⁸¹

264. The assertion that higher capital requirements necessarily cut lending has been questioned. Announcing the FPC's recommendations on capital levels, Sir Mervyn King concluded that “far from reducing lending, today's recommendations will support lending and promote growth”.⁵⁸² He told the Commission:

it is not unreasonable for the FPC to say that it wants banks either to raise more capital or to restructure the balance sheet in a way that does not undermine lending to the UK real economy. To link this to the recent lending figures, we knew when we created the Funding for Lending Scheme that there were at least three major UK banks that were going to contract their balance sheet on their lending to the UK real economy. There was nothing we could do about it. What we could do was design a scheme that would give them an incentive to contract their lending to the UK real economy by less than they would otherwise have done, and I think we have achieved that.⁵⁸³

The Chancellor also noted that banks have other ways to meet higher capital requirements:

581 “Biting the hand that lends”, *The Times*, 27 March 2013

582 “RBS and Lloyds to raise extra £9bn”, *The Financial Times*, 27 March 2013

583 Q 4539

They can give themselves—they have been doing this—more capital by restructuring their businesses, getting out of capital-intensive businesses and, if necessary, disposing of some of the assets they have.⁵⁸⁴

John Fingleton noted that not all lending undertaken by banks has necessarily been desirable:

You hear all this cry about the need for extra lending in the economy; we also need to deleverage as an economy. We are too debt-addicted as an economy. What we need is discriminating bankers who are capable of distinguishing between the innovative, efficient growing businesses and the others.⁵⁸⁵

Attractiveness of banks for investment

265. Some investor groups acknowledged the impact that standards failings in banks have had on investors. The National Association of Pension Funds (NAPF) told us:

Our members have been impacted by the failings in the standards of governance and lack of a positive culture within some of the world’s largest banks which have led to significant losses in shareholder value and thus a direct impact on pension funds. Episodes such as the manipulation of LIBOR and Euribor; the mis-selling of PPI to individuals and interest swap products to SMEs; the failure to prevent money laundering and unauthorised transactions involving customers’ money demonstrate why the NAPF believe improvements are needed.⁵⁸⁶

266. Nevertheless, some investor groups told us that measures intended to reform banking risked making the major banks unattractive to investors. In a recent report, the Association of British Insurers (ABI) argued that the threat of further regulatory change was jeopardising these potential returns and was therefore affecting investment in banks:

Investor appetite is significantly adversely affected by lack of regulatory clarity, as well as by concerns that the UK may impose more stringent requirements than other jurisdictions. Investors are also looking for an integrated approach, as opposed to piecemeal reform. Continuing uncertainty over the structure of the industry and the regulatory environment impairs the ability of the sector to help finance growth.⁵⁸⁷

In their written submission, the ABI said that existing regulatory changes “should be given time to work” and urged the Commission to concentrate on supporting existing initiatives within banks:

The Commission will [...] be most effective if it focuses on changes of culture in banking that are already underway, and on encouraging those who are trying to lead this.⁵⁸⁸

584 Q 4336

585 Q 2366

586 Ev 2160

587 Association of British Insurers, *The Investibility of UK Banks*, December 2012

588 Ev 743

The NAPF made a similar point, suggesting that “recent amendments to the corporate governance framework [...] should be given a period to embed before further regulatory action is taken” and arguing against further change until the impact on behaviour of measures already introduced could be assessed.⁵⁸⁹

267. Bank investors prior to the crisis were accustomed to high rates of return. The ABI reported that the UK banking sector delivered average return on equity of 24.6 per cent between 2000 and 2007. This was significantly above the average return on equity of 14.4 per cent throughout the 1990s, and was made possible largely through a 62 per cent increase in gearing from 21 times to 34 times, while return on assets grew only 7 per cent.⁵⁹⁰ The ABI stated that investors have acknowledged a return to this situation is not desirable:

The consequences of driving up profitability, by driving up leverage, remain all too fresh in investors’ minds from the financial crisis. [...] If a bank appears to be generating an ROE that is out of line with the banking cycle or with its peer group, investors will need to understand why.⁵⁹¹

268. The cost of capital for banks will be related to their perceived riskiness. It is widely accepted that if reforms improve the stability and reliability of banks, the cost of capital which investors demand from them should decrease, although the magnitude of this effect is debated. The ABI report went on to suggest what the minimum returns on different types of banking might have to be:

Discussions suggest that cost of equity for a Retail Banking business is in the range of 8 per cent-10 per cent, with Investment Banking around 15 per cent. Thus a blended Universal Banking cost of equity might initially be in the 11 per cent-12 per cent range.⁵⁹²

Banks must be able to deliver returns which at least meet their cost of capital over the economic cycle, not just in order to attract new capital but also to ensure they maintain their existing levels of activity. If banking were to become so unprofitable that it did not meet its cost of capital, over time shareholders might put pressure on banks to shrink their balance sheets. However, it is possible that investors may put more pressure on banks to reduce their cost bases. This would raise their capital ratios above the required levels, at which point banks could return excess capital through dividends or share buy-backs, for shareholders to invest in more productive sectors.

269. However, while shareholders may not be able to enjoy the historic returns that used to exist in banking, there are few signs that banks will not be able to meet their cost of capital over the longer term once reforms have taken place and the economy picks up. The Chairman and Chief Executive of Lloyds Banking Group made clear their view that retail

589 Ev 1263

590 Association of British Insurers, *The Investibility of UK Banks*, December 2012

591 *Ibid.*

592 *Ibid.*

and commercial banking in the UK already offers sufficient returns to meet its cost of capital, even during what is a difficult period:

There is a view, perhaps, that retail banking cannot be profitable, cannot be appropriately profitable and cannot meet its cost of capital. [...] We actually believe that retail banking, carried out with good cost control, where conduct is a gateway to incentive compensation [...] can make money for shareholders.⁵⁹³

the SME sector in the UK is a sector that can clearly provide a return that matches the cost of capital. I can tell you that presently, as we speak, the return on our SME business is somewhat higher than the cost of capital—not a lot, because we are at a difficult moment in time, but it pays the cost of capital.⁵⁹⁴

270. Institutional investors are misguided in their opposition to further change in banking and its regulation. Shareholders have not been well-served by poor banking standards in the past, having seen many of their pre-crisis gains wiped out by the crash and by the cost of dealing with conduct failures. In many cases, institutional investors only had themselves to blame. They were scarcely alert to the risks to their investments prior to the crash, but were mesmerised by the short-term returns and let down those whose money they were supposed to be safeguarding. With banks required to hold more capital, the potential liability of shareholders will be greater. If higher capital requirements make banks less vulnerable to disasters in the future, those banks are a more attractive investment. Further reforms will carry a cost in the short term, but an effectively-reformed banking sector subject to less uncertainty will be a better long-term recipient of investment.

271. Banks find themselves simultaneously exhorted to comply with costly new regulations, strengthen their capital and liquidity, and yet at the same time provide generous credit and cheap banking services to all. It is important to recognise the tension between these objectives, and to accept that beneficial reforms may also involve some costs, particularly if the implicit subsidy from taxpayers is to be reduced. These costs will need to be borne not only by shareholders and employees, but also in part by customers who will have to pay the appropriate price for the services they receive. The best way of ensuring that these costs are kept low is to ensure that there is effective competition and that market discipline applies to the banking sector. However, the commonly-heard argument that forcing banks to raise capital will hurt lending is false. Banks may well be reluctant to raise new equity capital since this depresses their return on equity and might be expensive, diluting current shareholdings. Nevertheless, if they do raise capital of the right kind this provides new funds which can be lent out to the economy, since capital does not simply sit idly on the balance sheet. If regulators allow banks discretion over how they achieve higher risk-weighted asset ratios or leverage ratios, some banks may choose to reduce lending and shrink their balance sheets instead of raising new capital. However, regulators can demand an increase in absolute capital levels to avoid this, as the Financial Policy Committee has already made clear.

593 Q 3481

594 Q 3480

Overcoming resistance

272. In a speech on 4 February 2013, the Chancellor of the Exchequer encouraged this Commission to “come forward with far-reaching proposals” relating to professional standards and culture.⁵⁹⁵ The Secretary of State for Business, Innovation and Skills has also suggested that “root-and-branch reform of the banking sector is inevitable”.⁵⁹⁶ The brave rhetoric of politicians is not always matched by reality. **Faced with proposals for solutions that match the depth and severity of the crisis in banking standards and culture, politicians will be given many reasons to shy away from the necessary reforms. Opponents of further reforms claim that such reforms have been rendered unnecessary by reforms already being implemented, that they will damage the competitiveness of the City and cost jobs, and that they will harm banks’ ability to support the rest of the economy.**

273. **The UK’s competitiveness will be threatened in the long-term by blindness to the dangers associated with poor banking standards and culture. If the arguments for complacency and inaction are heeded now, when the crisis in banking standards has been laid bare, they are yet more certain to be heeded when memories have faded. If politicians allow the necessary reforms to fall at one of the first hurdles, then the next crisis in banking standards and culture may come sooner, and be more severe.**

595 HM Treasury, Speech on the Reform of Banking by the Chancellor of the Exchequer, Rt Hon George Osborne MP, 4 February 2013

596 Speech by Secretary of State for Business, Innovation and Skills on 6 February 2013

5 Better functioning markets

Introduction

274. In an editorial to introduce its “capitalism in crisis” series, *The Financial Times* remarked that “the crisis flows from a lack of capitalism where capitalism was most needed”.⁵⁹⁷ The Church of England Mission and Public Affairs Council made a similar point to us in evidence, noting “banks have been championing a free market ideology while claiming exemption from its rigours”.⁵⁹⁸ Banking standards are in crisis partly because markets have not operated effectively to fulfil their role in disciplining participants, rewarding success, penalising failure and responding to consumer needs. Banking standards have been a casualty; all too often the story has been one of unmerited rewards, insufficient penalties for failure and consumer detriment.

275. In calling for better functioning markets we do not reject a role for regulation in banking. Regulation and supervision are required, among other important tasks, to provide a fair and reliable framework for competition to take place and to minimise systemic risk. As set out in the chapters that follow, we do not believe that the market is the means for solving all the problems in banking standards we face. Market discipline is a powerful and efficient force for change. However, the financial crisis demonstrated, particularly in view of the position of banks that proved too big to fail, the need for strong regulation to protect the public interest. Nevertheless, when market remedies can be found, they should be deployed.

A vital utility role

Serving vulnerable members of society

276. In an increasingly cashless society, access to a transactional bank account has become crucially important. Employers and landlords often require an account for payment of wages or rent; utility companies and councils typically offer discounts for payments by direct debit; and consumer goods are often available more cheaply online than in stores. Bank accounts are the overwhelmingly dominant means by which consumers access electronic payment and transaction services. Tony Greenham, Head of Financial Services at the New Economics Foundation (NEF), told us that:

Retail banking, and specifically the provision of transactional banking services and of responsible affordable credit, is different from any other consumer product and should be explicitly recognised as such. It is a basic utility and the lifeblood of the economy. There is a positive impact for society as a whole if all adults are given access to these services, in all communities and areas of the country.⁵⁹⁹

597 “Ruling Capitalism”, *The Financial Times*, 26 January 2012, www.ft.com

598 Ev 960

599 Ev 1473

277. For some sections of society, accessing these services may be challenging, and so banks might be perceived as denying them the opportunity to participate in many every day activities. Yvonne MacDermid, Chief Executive, Money Advice Scotland, said that being able to access a bank account was akin to “allowing people to participate in civic society”.⁶⁰⁰ Nick Waugh, Social Policy Officer, Citizens Advice, explained that inability to access a bank account may even result in a denial of employment, as without a bank account:

you are either completely unable to accept a job, because you cannot get wages, or you have to pay money to accept your wages, because you need to pay a cheque-cashing fee.⁶⁰¹

278. People are unable to access bank accounts for a number of reasons. Bank accounts tend automatically to include an unsecured lending facility in the form of an overdraft, so those with poor credit histories may have difficulty opening this type of account. Banks also require certain proofs of identification before individuals can open a bank account, which some may find difficult to provide. Specific groups may be excluded. For example, of the major UK banks currently only Barclays provides bank accounts to undischarged bankrupts. Some communities may also have difficulty physically accessing banks. Yvonne MacDermid described:

rural and island communities in Scotland, where people are not getting access to choice at all and in some cases they have to travel many, many miles to get to a bank.⁶⁰²

279. The Government and banks have gone some way to addressing the issue of financial exclusion. Following a report to the Treasury by the Social Exclusion Unit in November 1999, highlighting the importance of access to basic account services, the banking industry worked with the Government to introduce a basic bank account founded on a common model which was “specifically designed to address the needs of the financially excluded”.⁶⁰³ However, despite progress over the last decade, witnesses to the Commission suggested that there are signs that progress in both the number and quality of basic bank accounts is slowing. The Treasury Committee reported in August 2012 on the denial of access to third-party cash machines for basic account holders of Lloyds and RBS.⁶⁰⁴ Sian Williams, Head of Financial Inclusion at Toynbee Hall, believed that the standards of basic accounts were falling, saying “we know that banks are rolling back from the level of provision in 2009, specifically around quality.”⁶⁰⁵ It has also been suggested that the process of opening a basic bank account is sometimes difficult for consumers. Sue Edwards told us that:

we get evidence all the time of people going into a bank to open a basic bank account and being made to feel very small. The discussion might take place in a public area

600 IQ 109

601 KQq 21, 32

602 IQ 87

603 HM Treasury, *Promoting financial inclusion*, December 2004, p 5

604 Treasury Committee, Third Report of Session 2012–13, *Access to cash machines for basic bank account holders*, HC 544

605 Q 3727

with the bank staff raising their voice: "This person wants a basic bank account!" We sent our researcher around all the banks in the area local to our office to get information about basic bank accounts, and what was really interesting is that only in one bank could you go and get the information about the basic bank account without talking to a member of staff.⁶⁰⁶

In the context of these falling standards, Sir Brian Pomeroy warned of a "race to the bottom, which means banks withdrawing features precisely to deter customers".⁶⁰⁷ Therefore even the most vulnerable in society, who might not experience banks in their day-to-day business dealings or read the business pages of newspapers may view banks as opaque bodies who refuse to help them access the services they offer and that have come to be seen as a necessity by most people.

Underpinning utility provision

280. Access to a transactional bank account has become a necessary condition of financial inclusion. While certain products, such as prepaid cards, provide a partial substitute, they cannot carry out direct debits or standing orders, and typically attract fees far in excess of those applied to an ordinary account. The Commission has received no evidence to indicate that technologies are in development in the UK that would provide an alternative to a bank account.

281. The Government's policy on Universal Credit, which could require recipients to have a bank account to receive benefits, has heightened the importance of ensuring the remaining 3 million unbanked individuals in the UK are able to access a basic transactional account should they want one: eight out of ten in this group are in receipt of income-related benefits.⁶⁰⁸ Robin Taylor, Head of Banking at The Co-operative Bank, believed that a rise in demand for basic accounts was likely to follow from these changes:

There is going to be, in our opinion, an awful lot of customers wanting basic bank accounts later in the year and we need to ensure that we have a consistent basis on which they can open accounts and that there are some consistent accounts that they can open and have access to cash, etc. That is vital.⁶⁰⁹

282. Significant progress was made during the 2000s in improving access to basic accounts owing to effective co-operation between banks, Government and the third sector. However, basic account standards have started to fall in recent years: banks, fearful of attracting a disproportionate market share of an unprofitable product, have started withdrawing their features and underselling them in favour of standard current accounts. At a time when access to basic account services is becoming increasingly important, there is evidence of a 'race to the bottom' on standards and access to these products.

606 KQ 4

607 Q 3733

608 Financial Inclusion Taskforce, *Banking services and poorer households*, December 2010, para 22

609 KQ 116

283. Following a consultation and a subsequent Recommendation, the European Commission recently proposed a Directive that creates a right for EU citizens to open a payment account with basic features, irrespective of their financial circumstances. The Directive specifies minimum standards that include transactional services, direct debit, a payment card, ATM access and the absence of any overdraft.⁶¹⁰

284. In establishing a guarantee of access to a basic bank account, a number of considerations must be taken into account:

- how to ensure that minimum standards for such accounts are adhered to, and updated in the light of technological and economic change;
- how best to promote such a guarantee to those who are currently unbanked;
- how to ensure that identification requirements and sales incentives do not militate against customers applying for and being offered basic accounts;
- how to distribute the burden of providing basic accounts fairly between providers; and
- how to ensure that the guarantee of a basic account does not adversely affect the size and functioning of the ordinary current account market.

We discuss these issues below.

285. Banks have no apparent profit incentive to improve the standards of basic accounts or enhance their features. Consequently, increasing variability has arisen in banks' basic account offerings, partly through the selective adoption of money management features, and partly through restrictions on access to the ATM network and counter services. Both ATM access and money management features are particularly important for basic account holders, many of whom budget in cash and operate their accounts with low balances, as noted by Sue Edwards, Head of Consumer Policy at Citizens Advice:

A lot of basic bank account holders budget in cash. They often withdraw all their money and then use it to pay their bills, buy their food and go about their daily lives. [Access to cash] is the key feature really.⁶¹¹

It is therefore important that any minimum standards are monitored, reviewed and updated where necessary in light of technological and economic change, so that the floor they are intended to create does not become a ceiling.

286. Minimum standards and a guarantee of an account may be of little practical benefit to the unbanked if they remain unaware of either the existence of basic accounts, or their right to open one. It is important that a guarantee of a basic account is properly promoted, in bank branches, in financial education syllabuses, and by the Government if it decides to require that benefit payments be made into a bank account; that ID requirements are clear and consistent between banks; and that sales incentives do not militate against basic

⁶¹⁰ Commission Recommendation on access to a basic bank account, 2011/442/EU; Directive of the European Parliament and of the Council, COM(2013) 266

⁶¹¹ KQ 4

accounts being offered where this is in customers' best interests. In evidence to the Panel, Sue Edwards expressed concern that existing promotion and sales incentives for basic accounts risked stigmatising applicants:

we get evidence all the time of people going into a bank to open a basic bank account and being made to feel very small [...] only in one bank could you go and get the information about the basic bank account without talking to a member of staff. Generally, you have to talk to a member of staff who is not so interested in giving you any information about a basic bank account; what they want you to have is a packaged account.⁶¹²

287. Based on figures provided to the Commission by the major banks, the large banks already spend approximately £300m per annum providing basic bank accounts. It is important in principle, and for the proper functioning of the market, that the financial burden is spread evenly across the industry. Some banks are already doing more than others: Lloyds and Co-op have market shares well in excess of their share of the standard current account market; and of the major UK banks Barclays are the only provider offering services to undischarged bankrupts. This disparity was noted by Anthony Warrington, Director of Current Accounts at Lloyds, in evidence to the Panel:

I would say some banks take the responsibility [to provide basic accounts] more seriously than others. I would point to the different market shares and levels of effort that different organisations put into providing basic bank accounts. At Lloyds Banking Group we have a very large market share of this sector.⁶¹³

288. If a “guaranteed” basic account affected other parts of the market by attracting those customers who would otherwise have chosen a more profitable account, the costs could be higher. Banks should thus remain able to differentiate between standard and basic accounts in a way that reflects the needs and characteristics of their customers. This may involve offering features that may make a standard account more attractive than a basic one, but do not discriminate on access to the core utility functions necessary for financial inclusion, such as interest on balances in credit. Underpinned by well specified minimum standards and an approach to sales that reflects customers' best interests, there is no reason why a guarantee should affect the size of the existing market for ordinary current accounts.

289. UK banks already voluntarily spend £300 million per annum providing basic bank accounts to millions of customers who might otherwise be unbanked. Their historic attempts to address the problem of bringing the unbanked into the financial system are to be applauded. However, the Commission notes that the commitment of the banks to basic bank account provision varies markedly across the sector which results in the risk that such provision will be eroded in a so-called ‘race to the bottom’. We received evidence that the most recent attempts by the industry to rectify this had stalled. Christine Farnish, Chief Executive, Consumer Focus told us that Consumer Focus had recently “convened an industry/consumer forum to broker agreement on minimum standards for basic bank accounts that all main banks operating in the UK would sign up to”, but that agreement

612 KQ 10

613 KQ 64

had not been reached on a number of key issues.⁶¹⁴ She commented that “We are very disappointed that the banking sector as a whole has not risen to the challenge—and opportunity—of demonstrating its commitment to responsible banking and service to all sections of the public,” but added that “Lloyds Banking Group, Barclays and the Coop Bank have agreed to work together on a progressive package of minimum standards for basic bank accounts”.

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

291. It is important to ensure that the money being spent by the banks in this area is being spent in a way which represents best value for money. It may be the case that cooperation between the banks on basic bank account provision could yield cost savings, as could cooperation with other bodies. The industry, working together with other interested parties such as community development finance institutions, credit unions, consumer groups and those representing segments of society who are heavy users of basic bank accounts, need to consider whether such provision could be delivered in alternative ways which ensures high quality cost-effective provision. For example, an alternative approach could be for banks community development finance institutions, credit unions and other providers to work together in city-based or regional partnerships to develop local strategies for ensuring that the right to a basic bank account can be realised by all. The Commission recognises that participation in these partnerships may need to be obligatory, and that evidence of commitment to the

614 K Ev 32

development of local and community-based financial platforms should be required for banks to avoid mandatory participation in basic bank accounts.

292. The Government also needs to ensure that the agreement, voluntary or not, is underpinned by a requirement on the FCA to uphold minimum standards. As part of its role in this area, the FCA should have responsibility for collating and publishing data on the market share of providers in the basic bank account market. If the FCA does not currently have sufficient powers to assume this role, it would need to be given them. The provision of statistics is needed on the numbers of unbanked people, together with figures showing each bank's share of the basic account market in relation to its overall current account market share. This data should be periodically produced by the FCA.

Community finance and poorly-served communities

293. We also examined whether the mainstream banking sector adequately served the needs of all consumers as well as all communities. The Community Investment Coalition told us that “a significant proportion of our society cannot access the financial services that they need on fair and affordable terms”. The consequence, they said, was that “households unable to access appropriate, mainstream financial services [...] often have little recourse but to survive on high cost credit”:

Over four million individuals are borrowing from lenders with very high interest rates (typically 450 per cent–2500 per cent APR), trapping them into a spiral of increasing debt [...] the recent rapid expansion of payday lenders and pawnbrokers, providing credit to households and small businesses, shows that while demand for credit remains strong, access to credit offered on affordable terms remains a problem for many. We believe that this problem is greater in deprived communities.⁶¹⁵

294. As outlined in Box 7, community finance is “the provision of affordable financial services and other support to businesses, civil society organisations, homeowners and individuals with the aim of delivering economic, social or environmental benefits”.⁶¹⁶ A consequence of the lack of development of this sector, we were told, was that it left “large areas [...] of the economy, sections of society and geographical areas underserved”.⁶¹⁷

615 F Ev 95

616 *Ibid.*

617 Q 2950

Box 7: Community Finance

The New Economics Foundation explained the different types of organisations that make up the community finance sector:

- Cooperative banks, which are owned and controlled by investor members on the basis of one vote per member, rather than by shareholders in proportion to their financial stake, and tend to provide a wide range of financial services.
- Mutuals, which “are similar to cooperatives, but customers of mutuals automatically become members without having to buy a share”. Building Societies are the archetypal UK example.

Credit unions, a type of non-profit financial cooperative that have historically offered a restricted range of financial services—principally savings and loans services—to “members within a community that shares a ‘common bond’ such as living or working in a particular geographic area, or working for the same organisation”.

- Community Development Finance Institutions (CDFIs), which “lend money to businesses, social enterprises and individuals who struggle to get finance from high street banks and loan companies. They help deprived communities by offering loans and support at an affordable rate to people who cannot access credit elsewhere”.⁶¹⁸

295. The Community Investment Coalition made the case for greater support for the community finance sector. They argued that “the business models that drive mainstream financial institutions are increasingly unable to meet the needs of many small, marginalised and vulnerable communities, and the organisations that serve them”.⁶¹⁹ This point was repeated to us by Andrew Robinson, Director at CCLA and Chairman of the Board of Trustees at the Community Development Foundation (CDF), who told us of his experience:

My first job in the UK was to set up a charity. It was the first of its kind, and all it would do was lend money to not-for-profit organisations in depressed urban areas that couldn’t get a loan from a bank. Despite having viable plans they [...] couldn’t get through the [banks] credit scoring systems that were there. I think there was also a subtext there of deep disbelief that they could ever pay back, because of the types of people that were involved in the project, and that would be everything from BME women, not-for-profit organisations, micro enterprises and so forth.⁶²⁰

In *The Financial Times*, Will Goodhart, the UK CEO of CFA, argued that stock-picking, rather than engagement, was the investment managers’ priority: “Asset managers can choose to engage if they believe it will add value to their clients but their primary concern should not necessarily be with corporate decision making”.⁶²¹

618 F Ev114

619 F Ev 95

620 Q 2954

621 “Industry shows mixed response to the Kay review”, *The Financial Times*, 29 July 2012, www.ft.com

296. We received evidence contending that the UK should adopt similar provisions to those in the US Community Reinvestment Act.⁶²² The Act provided for a number of things, including forcing “the banks to disclose the level of bank lending and service provision within disadvantaged communities”.⁶²³ The legislation requires regular examination and grading of a lending institutions’ activities in poorer communities and has penalty mechanisms, including barring merger activity, if a lender is neglecting its community by extracting deposits without reinvesting through loans and branch presence.⁶²⁴

297. The Government, during the passage of the 2012 Financial Services Bill, promised that the Treasury and the BBA would work together with the large banks to provide similar information on a voluntary basis, but later invoked the threat of legislation if a voluntary disclosure regime was not put in place.⁶²⁵ The BBA and the large banks are currently working on the details of such a disclosure regime with plans expected to be finalised by the summer of 2013.⁶²⁶

298. Many individuals, businesses and geographical areas are poorly served by the mainstream banking sector. Many consumers have consequently opted for high-cost credit from payday lenders, some of whose practices have been a source of considerable concern. There can be a role for community finance organisations in supporting those whom the mainstream banking sector appears uninterested in serving. Given the benefits of a collaborative relationship, the BBA and the banks should be held to their commitment to refer declined loans to CDFIs. The effectiveness of current tax incentives, including Community Investment Tax Relief, intended to encourage investment in CDFIs by banks and other funders, should also be reviewed by the Treasury and, where necessary, re-designed to be more effective.

299. The Commission recommends that banks be required to commit to investigating ways in which they can provide logistical, financial or other forms of assistance to community finance organisations, in order to ensure that the community finance sector becomes strong enough over a period of years to work as a full partner with banks so that issues of unbanked individuals and communities are addressed.

300. Increased disclosure of lending decisions by the banks is crucial to enable policy-makers more accurately to identify markets and geographical areas currently poorly served by the mainstream banking sector. The industry is currently working towards the provision of such information. We welcome this. It will be important to ensure that the level of disclosure is meaningful and provides policy-makers with the information necessary accurately to identify communities and geographical areas poorly served by the mainstream banking sector. The devil will be in the detail of the disclosure regime which is put in place, including, for example, the question of whether such data will be disaggregated by institution and whether it goes beyond lending to small businesses.

622 F Ev 98, 131

623 F Ev 131

624 Written evidence from the New Economics Foundation to the Business Finance Green Paper, 20 September 2010

625 HL Deb, 12 November 2012, cols 1357-1358

626 BBA, Statement following speech by Secretary of State for Business, Innovation and Skills, 6 February 2013

The Commission therefore supports the Government’s proposal to legislate if a satisfactory regime is not put in place by voluntary means.

Competition in retail banking

Introduction

301. In Chapter 3, we noted that competition is deficient in key parts of the UK retail banking market, including personal current accounts and SME lending. These markets are characterised by oligopoly supported by an implicit guarantee to the major banks, high barriers to entry and limited switching between providers. In this section, we examine possible competition policy measures aimed at increasing banking standards.

302. Parliamentary pressure for the Government to take seriously the issue of increasing competition in the retail banking sector has been a noticeable feature of the current Parliament. The Treasury Committee’s 2011 Report *Competition and choice in retail banking* was extremely critical of the lack of competition in parts of the retail market and expressed concern about increased levels of concentration. It also outlined a set of policy recommendations to boost competition and improve consumer outcomes, including a regulatory regime which did not discourage new entry.⁶²⁷ Progress by the Government has been too slow. That said, pressure from Parliament combined with the establishment of this Commission—and the decision to make competition a focal point of our inquiry—finally appears to have acted as a catalyst for the Government to take this issue more seriously. Many of the issues we have taken evidence on—for example, reforms to the payments system, and barriers to entry and growth—have resulted in the Government and other relevant bodies putting forward their own proposals.

Competition and standards

303. We examined the extent to which low standards and poor consumer outcomes were the consequences of a lack of competition in some parts of the retail market as well as the historic role of regulation versus competition as a mechanism to improve standards and consumer outcomes. Much of the evidence we received suggested that, over the preceding decades, there had been an emphasis on regulation rather than competition which had proved counter-productive.

304. For example, Dr Diane Coyle, Founder of Enlightenment Economics, argued that “competition is a really powerful force for serving customers”. In comparison to regulation, she believed that competition was:

Less direct, perhaps, but it is more effective, and particularly in a forward-looking way, not just in terms of fixing abuses or poor aspects of service that are already known about. I am thinking about everyday standards: not just mis-selling of PPI

⁶²⁷ Treasury Committee, Ninth Report of Session 2010–12, *Competition and choice in retail banking*, HC 612

products but, for example, under-investment in IT systems that gave rise to the problems that we saw at NatWest a little while ago.⁶²⁸

Clare Spottiswoode concurred with the views expressed by Dr Coyle. She told us that “if there is vibrant competition, companies cannot behave badly, because if they behave badly, they will lose customers”:

People move their custom if you do not provide a good service with a good product at a good price. If you do not do these things well, you lose your customers. Customers become the heart of your business [...] It is not that competition deals with culture directly; it is that if you have a bad culture, you do not succeed. It is an indirect and really strong impact of good competition.⁶²⁹

Ms Spottiswoode warned that without “that force for competition we will get more and more supervision, more and more rules and more and more ossification of the system”.⁶³⁰ Andrew Lilico, Director of Europe Economics, said that “competition maintains standards principally via consumer pressure. If a bank does not scrutinise the activities of its staff and those it deals with, in a competitive environment consumers would leave for other banks”.⁶³¹ Craig Donaldson, Chief Executive of Metro Bank, gave us an example of how he believed competition from his firm had led to higher standards:

People who were waiting two weeks to get their cards delivered. We start doing it instantly in store for new customers and existing customers, and suddenly we are seeing some of the larger banks, who said that it could not be done and that customers did not want it, starting to do it [...] You need competition to deliver what customers want.⁶³²

305. Clive Maxwell, Chief Executive, Office of Fair Trading, told us that improvements in banking standards would be an indication that markets had become more competitive. He said he was “concerned about some of the cultural changes going on within banks and about their behaviours, approaches and business models, where we are still waiting to see some evidence of change in the way that banks approach markets and their consumers”.⁶³³ He went on to tell us that “when competition works well, you get providers and businesses focusing on what really matters to their consumers and to their customers. They try to improve their service levels. They push down prices and pass on those savings to their customers”.⁶³⁴ He contrasted such a state of affairs with the situation in the retail market:

You can also have competition working less well in markets. If, for example, the customers in that market do not understand the prices that they are paying or if they

628 Q 2321

629 Q 2324

630 Q 2361

631 Ev 1205

632 FQ 52

633 Q 3069

634 Q 3070

do not have good ways to understand the service levels and the quality they are seeing, the competition is not necessarily focussed on what the customer wants.⁶³⁵

Mr Maxwell concluded by telling us that he was “not yet convinced that banks are sufficiently focused on delivering the sorts of products and services that their customers really want, as opposed to finding ways to charge them for things they do not necessarily want”.⁶³⁶

306. We concur with the evidence received which has stressed the role that competition can, and should, play to bring about higher standards in the banking sector. The discipline of the market can and should be an important mechanism for raising standards as well as increasing innovation and choice and improving consumer outcomes. Effective market discipline, geared to the needs of consumers, can be a better mechanism for improving standards and preventing consumer detriment than regulation, which risks ever more detailed product prescription. A policy approach which focuses on detailed product regulation alone could inhibit innovation and choice for consumers.

Direct measures to reduce concentration

307. In Chapter 3, we noted that the major UK banks are probably too big. Sheer size can prevent effective management or regulation and can make holding individuals to account difficult. The major banks receive an implicit guarantee from the taxpayer as they remain too systemically important to be allowed to fail. They are also so large that, combined, the major banks form an oligopoly in many markets.

308. Adam Posen argued that a “big dumb rule” in the form of “some size limit on share of total deposits or total lending in the economy” was necessary to reduce the size of the largest banks.⁶³⁷ Paul Tucker, Deputy Governor of the Bank of England, noted that there were international examples of such practices:

One approach, which has been used elsewhere, is to prevent concentrations via an explicit cap on the market share that banks can accumulate through acquisitions. For example, the United States bans acquisitions that would result in a bank controlling more than 10 per cent of the country’s insured deposits. (The rule does not prevent banks from crossing the 10 per cent line organically.) The same broad approach could, in principle, be related to a bank’s share of loan markets, or to GDP etc.⁶³⁸

Michael Cohrs elaborated on the US example, noting that, while it was intended for use in cases of mergers and acquisitions, “it has been generally applied by the regulators as a rule of thumb”.⁶³⁹

635 *Ibid.*

636 *Ibid.*

637 Q 2710

638 Ev 1381

639 EQ 16

309. The Chancellor of the Exchequer expressed concern about a rapid introduction of a size limit for banks:

I think that would have a pretty dramatic impact if you introduced it today. It would cause quite a lot of uncertainty in the banking sector, to put it mildly.⁶⁴⁰

Box 8: A history of oligopoly

The UK has a long history of oligopoly in retail banking. In *Anatomy of Britain*, Anthony Sampson noted concerns about concentration dating back to the early twentieth century:

These giants took their present shape, after a succession of swallowings of smaller banks, at the end of the first world war, after which the Treasury became worried, and ‘made it known’ that they would disapprove of any more amalgamations⁶⁴¹

Sir Alan Budd told us that “the clearing bank system in the UK, prior to Big Bang, was commonly described as a ‘cosy cartel’” and that “mergers were permitted because the authorities believed that the surviving banks would not take undue advantage of their market position”. This was due to “an implicit gentleman's agreement [...] between the banks themselves and between the banks and the Bank of England”.⁶⁴²

Sir Donald Cruickshank’s 2000 report, *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, expressed grave concern about concentration in pivotal markets:

The Review considers further action is necessary, in particular to prevent anti-competitive mergers. The Review found the structure of several banking markets, most notably the supply of banking services to SMEs and the supply of current accounts to personal customers, to be highly concentrated.⁶⁴³

As the Independent Commission on Banking noted, the market is now “considerably more concentrated” than it was at the time of the Cruickshank Review.⁶⁴⁴ UK retail banking is now arguably more concentrated than ever.⁶⁴⁵

310. Adam Posen explained some practical concerns with establishing a rapid increase in competition:

people are not going to go to Joe’s bank the day it is set up. You need a branch network and you need a computer infrastructure and you need some competence and some confidence from people.⁶⁴⁶

640 Q 4349

641 Anthony Sampson, *Anatomy of Britain* (London, 1962)

642 Ev 885

643 The Banking Review, *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, March 2000, para 30

644 Independent Commission on Banking, Final Report, September 2011, para 6.8

645 Bank of England, *On being the right size speech*, Andy Haldane, 25 October 2012, chart 2

646 Q 2696

Virgin Money argued that “the creation of new banks through combinations of branches of the large banks would be operationally and culturally challenging, and it would probably take some time before such new banks could become effective challenger banks”.⁶⁴⁷ They also expressed concern about the practicalities of rapid divestments to increase competition:

The view has been put forward that the large banks should be broken up to create new challenger banks. Although we think that this would in theory be good for competition, we are not sure that this is practical, given the difficulties experienced by RBS in separating the branches which it had agreed to sell to Santander, and by Lloyds in finding a buyer for its divestment.⁶⁴⁸

311. Since that submission was made, the scheduled divestments of branch networks by both RBS and Lloyds have been aborted. The collapse of the sale of RBS branches to Santander UK in October 2012 was attributed to delays in finalising the deal and incompatibility between the two banks’ IT systems,⁶⁴⁹ which Santander argued would not result in a “seamless journey for customers”.⁶⁵⁰ The Co-operative Banking Group explanation of their decision to withdraw from its proposed purchase of Project Verde branches from Lloyds in April 2013 illustrated the challenges currently posed by the wider economic climate:

against the backdrop of the current economic environment, the worsened outlook for economic growth and the increasing regulatory requirements on the financial services sector in general, the Verde transaction would not currently deliver a suitable return for our members within a reasonable timeframe and with an acceptable level of risk.⁶⁵¹

312. The fact that the largest banks have gained their dominant positions in retail banking markets, in part through their receipt of a ‘too important to fail’ subsidy and bail-outs, is a very unhealthy situation for effective competition. These increases in concentration are bad for competition and bad for stability.

Barriers to entry

313. As discussed in Chapter 3, barriers to entry in the retail banking market remain a fundamental obstacle to effective competition. Given the importance of brands in banking,⁶⁵² the decline in trust in major banks in the light of both the financial crisis and conduct failures might be expected to offer an opportunity to new entrants. RBS made this point in evidence to the Treasury Committee:

647 Ev 1428

648 FR Ev 157

649 “Santander pulls plug on RBS deal”, *The Financial Times*, 12 October 2012, www.ft.com

650 “Santander UK comments on the RBS deal”, Santander Stock Exchange Announcements, 15 October 2012, www.aboutsantander.co.uk

651 “The Co-operative Group Announcement re: Lloyds Bank Branch Assets”, *The Co-operative news*, 24 April 2013, www.co-operative.coop

652 Q 248, FQ 27

The financial crisis has in fact created opportunities for potential new entrants. The reputation of several incumbent banks has been damaged by the financial crisis (to the advantage of new or newer entrants).⁶⁵³

314. There has been some evidence of new entrant activity. Metro Bank has entered the retail market,⁶⁵⁴ while Virgin Money and Tesco Bank also have a retail presence and are poised to offer personal current accounts.⁶⁵⁵ In April 2013 the Post Office announced its intention to enter the personal current account market. Subsequently, it has launched three different types of account: a “free in credit” standard account, a packaged account and a control account. The Post Office describes the control account as “a simple, straightforward account that protects you from unexpected, expensive bank charges and from accidentally going overdrawn for just £5 per month”. The three accounts, which are provided by Bank of Ireland UK, are currently available in 29 branches in East Anglia. The Post Office plans a full roll-out across its network in 2014. Some new firms, such as Aldermore and Handelsbanken, have entered the SME market.⁶⁵⁶ However, challengers to the major firms are currently relatively niche offerings. John Fingleton told us that there has been “very little new entry in the banking market generally”.⁶⁵⁷

315. Nationwide has previously argued that retail banking in the UK is a relatively mature industry and therefore unattractive to new entrants.⁶⁵⁸ Anthony Thomson, co-founder of Metro Bank, disagreed, stating that the lack of new entrants is not attributable to a lack of desire on their part:

why, since the launch of Metro Bank in 2010, have there been no new lenders? It is not a lack of enthusiasm. In the past 12 months, I have spoken to several potential entrants. One of the leading consulting groups told me it had received 20 approaches in the past 18 months from individuals, local enterprise partnerships, local businesspeople and others. As one leading consultant told me, it falls into the “just too difficult category”. Why?⁶⁵⁹

Mr Thompson stated that there were three particular challenges facing new bank entrants: capital requirements, the authorisation process, and access to the payments system. We consider each below.

Prudential requirements and risk-weightings

316. Representatives of the challenger banks argued that new and smaller market participants were disproportionately affected by prudential regulation, creating a regulatory barrier to entry and expansion. Anthony Thomson wrote that “the amount that

653 Treasury Committee, Ninth Report of Session 2010–12, *Competition and Choice in Retail Banking*, HC 612-II, Ev 216

654 FQ 3

655 FQq 1-2, 27-28, 75

656 FQq 66, 76

657 Q 2322

658 Ninth Report from the Treasury Committee, Session 2010–12, *Competition and Choice in Retail Banking*, HC 612-II, Ev 186

659 “Time to open banking to new entrants”, *The Financial Times*, 24 March 2013, www.ft.com

entrants must hold is not commensurate with the risks that they generate, either in terms of depositors or the banking system”.⁶⁶⁰ Craig Donaldson contrasted Metro Bank’s capital requirements with those of those of the large banks, saying they were “at least three times higher”. This, he argued, imposed a “significant cost, which could be seen to be significantly anti-competitive”.⁶⁶¹

317. Jayne-Anne Gadhia expressed concern that challenger banks were required to hold capital commensurate with their planned size in several years’ time:

You are holding capital on day one for a bank that could be so much bigger in three to five years time, and that can be quite an expensive thing to do for a bank.⁶⁶²

This, Anthony Thomson suggested, was more of a problem for a rapidly growing bank than the capital ratio itself.⁶⁶³

318. Virgin Money submitted that large banks are given an “unfair advantage” by being permitted to calculate risk-weighted assets (RWAs) using an advanced internal ratings-based (IRB) approach rather than the standardised approach on offer to smaller banks and new entrants.⁶⁶⁴

Box 9: Prudential requirements for small/new banks

An issue raised frequently by new/small banks through the course of our inquiry was that prudential requirements for new/small banks created an unlevel playing field between such banks and their larger and longer-established competitors. The ICB has previously highlighted that small and new banks might be disproportionately affected by prudential regulation and face higher capital requirements than large banks:

they might be penalised for less experienced management or lack of a track record;

they might be required to hold extra capital to compensate for concentration in a particular market or geographical region;

or the risk weights on their assets might be higher due to using a standardised rather than advanced approach to risk-weighting.

With respect to the third factor, under the Capital Requirements Directive, levels of capital required for different types of risk are calculated using either a standardised or internal ratings based (IRB) approach.

Small and new banks typically use the standardised approach to risk-weighting, which as both the ICB and OFT have previously noted, can produce higher risk-weightings than the

⁶⁶⁰ “Time to open banking to new entrants”, *The Financial Times*, 24 March 2013, www.ft.com

⁶⁶¹ FQ 3

⁶⁶² FQ 1

⁶⁶³ “Time to open banking to new entrants”, *The Financial Times*, 24 March 2013, www.ft.com

⁶⁶⁴ Ev 1424

advanced methods used by large banks. This can place small and new banks at a competitive disadvantage as they will face more onerous capital requirements.

Small and new banks use a standardised approach because they often do not have the history of back data nor the experience of managing their assets required for the transition to the advanced approaches. Nor do they tend to have the scale to justify the investment required to move to an advanced approach.

319. In a 2012 report, the Basel Committee on Banking Supervision noted that “the potential for very large differences between standardised and internal models based capital requirements for a given portfolio is a major level playing field concern”.⁶⁶⁵ Phillip Monk, Chief Executive of Aldermore, gave the example that his bank was required to hold twice the capital for a given portfolio of residential mortgages as the average large, incumbent bank.⁶⁶⁶ Furthermore, the validity of the internal risk models used by large banks have been seriously questioned. This only exacerbates the distortion between large and small and new players. We discuss this issue in greater detail in Chapter 9.

320. In March 2013, the FSA published a review of regulatory barriers to entry and expansion in banking. The report states that the PRA will require start-up banks to hold proportionately less capital than major incumbents, a reversal of the situation that often occurred in the past, when the FSA was unduly concerned by the potential failure of non-systemic market entrants. Similarly, automatic new bank liquidity requirement premiums will no longer be enforced.⁶⁶⁷ Under the new regime, capital requirements for rapidly growing new banks will also rise gradually, meaning that they will not be required to operate on the same basis as incumbent firms for three to five years.⁶⁶⁸

321. The FSA review acknowledged that “the requirements to achieve IRB status are considerable for a small bank and that this may cause competitive distortions relative to banks undertaking similar business under the IRB approach”.⁶⁶⁹ It states that this problem will be tackled through taking steps to “reverse the existing under-estimation of risk in the IRB approach” and adopting a more flexible approach to setting capital planning buffers for new banks that are small, non-systemic and relatively easy to resolve.⁶⁷⁰ The review commits the PRA to providing support to new entrants who wish to move to the IRB approach.⁶⁷¹ The PRA should also review existing arrangements for banks such as Clydesdale, whose CEO told us not being able to use IRB meant they carried significantly

665 Bank for International Settlements Basel Committee on Banking Supervision, *Fundamental review of the trading book*, May 2012, p4

666 FQ 54

667 FSA and the Bank of England, *A review of requirements for firms entering into or expanding in the banking sector*, March 2013, pp5-9

668 *Ibid.* p44

669 *Ibid.* p10

670 *Ibid.* p43

671 *Ibid.* p53

higher cost of funds, which impacted their ability to compete in Scotland, where they have traditionally been the third player.

322. Jayne-Anne Gadhia argued that it was important to consider the appropriateness of capital ratios for large banks as well as for new entrants.⁶⁷² Lord Turner explained that the combination of the removal of capital and liquidity add-ons for new entrants, combined with global and domestic surcharges for systemic institutions, would result in a “significant shift” in their relative competitive positions:⁶⁷³

in the past, we have had pretty much the same capital and liquidity rules for new entrant banks as for existing player banks—indeed, we have tended to have capital or liquidity add-ons for new entrant banks, so they have been disadvantaged—but we are shifting to a process in which a new entrant bank will be able to run on the minimum legal requirement under CRD IV, which is a 4.5 per cent capital ratio, whereas RBS, Lloyds bank and HSBC will effectively have to be up at about 9.5 per cent or 10 per cent, once you allow for the 4.5 per cent plus the 2.5 per cent conservation buffer and the global SIFI surcharge or equivalent under the Vickers rule.

However, Lord Turner did caution that “these changes will not in themselves transform competitive intensity in UK banking”.⁶⁷⁴

323. The prudential reforms outlined in the FSA’s review of barriers to entry are to be welcomed as a long overdue correction of the bias against market entrants, who are, at least initially, unlikely to be of systemic importance. Although the concerns of challenger banks in this area appear to have largely been addressed, the practical application of the regulatory authorities’ laudable statements needs to be monitored closely.

The bank authorisation process

324. The FSA review of barriers to entry also contained proposals to streamline the bank authorisation process. The previous system was criticised in evidence to us as time consuming and costly. For example, Burnley Savings and Loans told us:

The authorisation process should be more encouraging. At present, it takes too long, costs too much and it requires would-be banks to make huge investments in staff and IT before they have any idea if they are likely to be allowed to open.⁶⁷⁵

Martin Wheatley expanded on that last point, explaining the “Catch-22” situation that faced potential new entrants:

672 FQ 2

673 Q 4452

674 FSA and the Bank of England, *A review of requirements for firms entering into or expanding in the banking sector*, March 2013, p6

675 Ev 899

When we spoke to new entrant banks, one of the interesting things that they said was: “In order to set up, we need backers and capital. We need to employ the right people and to have systems, but we face this Catch-22 situation where, until we are authorised, we cannot get the capital or the people or the systems, and you are telling us that you cannot authorise us until you have those things in place.”⁶⁷⁶

325. Further concerns were expressed about the authorisation process. Andrea Leadsom MP told us that, in private, “potential bankers say that they do not find the FSA at all helpful to them”.⁶⁷⁷ Her point appears to be shared more widely amongst Parliamentarians. In a backbench business debate on the retail banking sector, secured by Ms Leadsom herself, a large number of participants spoke about the importance of encouraging new entry and ensuring the bank authorisation process did not act to discourage such entry.⁶⁷⁸ The OFT stressed that the authorisation process should not unduly disadvantage unusual business models:

Competition from outside the traditional banking model may also create challenges for the process of granting authorisation. It is important that regulators do not unduly constrain competition by taking the business model of incumbent and traditional banks as the starting point for the design of new rules in way that could disadvantage new technologies and innovative providers.⁶⁷⁹

John Fingleton made this point more succinctly, saying “there is a danger that anything new looks risky, and therefore we should not do it. We need new things at the moment”.⁶⁸⁰ The role of alternative modes of provision in improving banking standards is considered later in this chapter.

326. The FSA review outlined several changes to the authorisation process. These included:

- a six-month fast-track authorisation process;
- an alternative, staged process, enabling entrant firms to gain authorisation before being required to mobilise capital, personnel or IT infrastructure;
- additional support from regulators; and
- reduced demands for information.⁶⁸¹

327. In its final publication, the FSA reformed an authorisation process that has long stifled entry to the banking market. This reform was welcome, but long overdue. The Commission supports both the specific proposals and the broader approach set out in the review for encouraging new entry. However, for a very long time, the regulatory authorities in the UK have displayed an instinctive resistance to new entrants. This

⁶⁷⁶ Q 234

⁶⁷⁷ FQ 134

⁶⁷⁸ HC Deb, 12 July 2012, cols 147-192WH [Westminster Hall]

⁶⁷⁹ Ev 1274

⁶⁸⁰ Q 2366

⁶⁸¹ FSA and the Bank of England, *A review of requirements for firms entering into or expanding in the banking sector*, March 2013

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.

Access to payment systems

328. The August 2011 Treasury Committee Report on *The future of cheques* concluded that “The Payments Council is an industry-dominated body with no effective public accountability” and recommended that it be brought “formally within the system of financial regulation”.⁶⁸² In *Setting the strategy for UK payments*, the Government consulted on three options for improving the way payments strategy in the UK was made. These were:

- i. to build on the present approach to UK payments strategy by making a series of changes to the governance of and operation of the Payments Council;
- ii. to introduce a new public body, the Payments Strategy Board, to set strategy across the UK payments industry; and
- iii. to create a new statutory regulator for the payments industry, similar to those used in other regulated sectors such as gas and electricity, as recommended as “Paycom” in the 2000 Cruickshank Report.⁶⁸³

The second was the Government's preferred option.⁶⁸⁴ The consultation paper was dismissive of the statutory regulator option, stating that it would involve “a major increase in the overall regulatory burden” and did not consider it in detail.⁶⁸⁵

329. In February 2013, the Chancellor of the Exchequer made a speech in which he announced a more radical approach:

At the moment, a new player in the industry has to go to one of the existing big banks to use the payment system.

Asking your rival to provide you with the essential services you need at a reasonable price is not a recipe for success.

[...] There are no incentives on the big banks to deliver new and better services for users – like saving the cheque or creating new services like mobile payments.

[...] The system isn't working for customers, so we will change it.

I can announce today that the Government will bring forward detailed proposals to open up the payment systems.⁶⁸⁶

682 Treasury Committee, Eighteenth Report of Session 2010–11, *The future of cheques*, HC1147, p 3

683 HM Treasury, *Setting the strategy for UK payments*, July 2012

684 *Ibid.* p 6

685 *Ibid.* p 7

330. The Government’s revised proposals were subsequently set out in *Opening up UK payments*. This consultation proposed “bringing payments systems under economic regulation” with the establishment of “a new competition-focused, utility-style regulator for retail payments systems”,⁶⁸⁷ the underdeveloped third option in the original consultation. The Government explained that “a number of developments” had occurred which had led it to change its mind, including increasing concern “about the difficulties faced by both new entrants and existing small challengers in the UK banking market”.⁶⁸⁸

331. This policy, Sir Donald Cruickshank told us, was “close to [his] original recommendation, which is that someone with competition powers should be given the job of licensing and regulating the underlying networks. So that is back on the table, but we have lost a decade”.⁶⁸⁹ The principle of creating a payments regulator was also supported by Anthony Thompson who said that there was a simple solution to the problem of access to the payments system—“to introduce a payments regulator, to ensure that new entrants are not at best disadvantaged and at worst priced out of the market”.⁶⁹⁰

332. The consultation document sets out the competition problems that the Government is seeking to address:

a number of large banks dominate the industry at every level. These banks dominate the decision-making process of the Payments Council; own the payment schemes; operate as direct users offering services to consumers; and operate as agents for smaller financial institutions who do not want, or cannot obtain, direct access to the schemes. Because of their involvement at each level of operation, there is considerable opportunity for these banks to manipulate their involvement in the process for their own benefit.⁶⁹¹

333. The proposed new arrangements leave ownership of payments systems in the hands of overlapping groups of banks with the large banks predominant. The Government justified this by the potential innovation and efficiency benefits of competition between different payments systems with slightly different ownership arrangements. The consultation document concedes that the “nature of the market may mean that there is limited scope for these systems to compete with each other”.⁶⁹² It also acknowledges the “clear potential for owners of the payment systems to use their position to stifle innovation and competition”⁶⁹³ through the creation of barriers to entry.

334. We welcome the Government’s Damascene conversion to bring payments systems under economic regulation and establish a new competition-focused, utility-style

686 HM Treasury, Speech on the Reform of Banking by the Chancellor of the Exchequer, Rt Hon George Osborne MP, 4 February 2013

687 HM Treasury, *Opening up UK payments*, March 2013

688 *Ibid.* p 9

689 Q 149

690 “Time to open banking to new entrants”, *The Financial Times*, 24 March 2013, www.ft.com

691 HM Treasury, *Opening up UK payments*, March 2013, p 8

692 *Ibid.* p 19

693 *Ibid.* p 10

regulator for retail payments systems, along the lines originally proposed by Sir Donald Cruickshank in his 2000 review of competition in UK banking. The current arrangements, whereby a smaller bank can only gain access to the payments system via an agency agreement with one of the large banks with which it is competing, distort the operation of the market. Such agency agreements place small banks at a disadvantage, because the large banks remain in a strong position to dictate the terms on which indirect access to the payments system can be secured by smaller banks, even if there is currently no evidence of them doing so. The Government's proposed reforms will, however, continue to leave ownership of the payments system largely in the hands of the large incumbent banks. Continued ownership of the payments system by the large banks could undermine the proposed reforms, in view of the scope such ownership gives them to create or maintain barriers to entry. The Commission therefore recommends that the merits of requiring the large banks to relinquish ownership of the payments system be examined and that the Government report to Parliament on its conclusions before the end of 2013.

335. Craig Donaldson raised another barrier to entry and growth for small/new banks, which he believed acted to create an unlevel playing field between institutions. He told us that Government and local authorities had “huge amounts of deposits”, but which were not placed with “any of the challenger banks”.⁶⁹⁴

336. The Department for Communities and Local Government (DCLG) provides guidelines to local authorities on where to place their investments. The current guidance specifies that for short-term sterling deposits (specified investments), local authority funds should be deposited either with government bodies or other bodies with high credit ratings. They are also required to strongly consider the security, liquidity and yield of investments, with the former two taking priority. As the Local Government Association has explained:

The heart of a council's investment strategy is the decision about which institutions an authority will deposit money with. Authorities should only deposit funds with financial institutions that are of a sufficient financial strength to be included on a “counterparty list”

Counterparty lists are informed by an independent assessment of the financial stability of the institutions, the normal source of which is the rating given by one or more of the three main rating agencies. The agencies all give short and long-term ratings for financial institutions. Some give further information - for example about countries. The investment strategy sets out the minimum acceptable rating that an institution must achieve to be included on the counterparty list. The LGA has carried out research, this shows that whilst there are minor variations between individual counterparty lists - the general principle of placing deposits with highly rated institutions is a common feature.

337. The key role ascribed to credit ratings in assessing where to place local government deposits can serve to exclude particular institutions from receiving such deposits. As the

LGA has noted “not all financial institutions are rated by rating agencies, smaller UK building societies are typically not rated. Some authorities will still include these, recognising the extent of FSA regulation of this sector, but will lend them less money and only for shorter periods (e.g. 180 days)”.⁶⁹⁵

338. The Commission agrees strongly that local government deposits should only be held with financial institutions that can demonstrate their robust financial strength. A high credit rating is an important indicator of financial strength. However, it is just one indicator of financial strength. The suggestion of the Department for Communities and Local Government (DCLG) that deposits are placed with institutions with high credit ratings can have an adverse effect on banks without formal ratings. By effectively cutting off from access entrants to this source of funding, new and small banks face an unlevel playing field. The consequence is that, while the Government stresses the importance of encouraging new entry into the retail banking market, the current DCLG guidance acts in a way that puts new entrants at a competitive disadvantage.

339. Deposits held by financial institutions originating from central or local government make up a sizeable proportion of the UK deposit market. Provided that other measures of credit worthiness are in place, it would be a source of concern to the Commission if the guidance or rules in this area prevented such deposits from being held by small banks or other institutions without a formal rating. If so, this would constitute yet another example of an unlevel playing field between the large incumbent banks and small or new banks in the retail market which needs to be addressed. As a result, the Commission recommends that the DCLG review its guidance in this area to see whether it penalises new banks and consider the scope for such institutions to demonstrate credit-worthiness as well as liquidity and stability in other ways. A bank’s strength should not be measured solely by its credit rating, especially as the financial crisis demonstrated how many banks with strong pre-crisis credit ratings ran into serious difficulties.

Alternative modes of provision

340. We examined the role of alternative providers that provide alternative financial services to those offered by banks and traditional investment firms in the market for consumer and small business finance in competing with mainstream retail banks. Many have little or nothing in common with one another except for the fact that they are not mainstream banks.

341. The term “alternative provider” includes organisations, such as credit unions, Community Development Financial Institutions or cooperatives, with a broader set of objectives than profit maximisation and with business models that date back to Victorian times. It also encompasses relatively recent, smaller, non-bank entrants to the retail market, specialising in innovative forms of lending to individuals and businesses. Such firms have emerged and grown significantly over the last five years, driven in large part by

⁶⁹⁵ Communities and Local Government Committee, Seventh Report of Session 2008-2009, *Local Authority Investments*, HC 164-I, para 29

technological developments, particularly the growth of the internet. The most visible manifestation of this phenomenon thus far are the peer-to-peer lending (P2P) and peer-to-peer ‘crowdfunding movements’, which we define in Box 10.

Box 10: modern forms of alternative provision

Peer-to-peer lending comprises consumers or businesses lending to each other directly through an online marketplace as opposed to via a banking counterparty, with the P2P business operating the exchange to bring lenders and borrowers together—a process often referred to as disintermediation. P2P products are available to ordinary retail consumers who actively choose to lend their money in this way. P2P providers may spread a loan across multiple borrowers and similarly often aggregate lots of lenders to produce a loan for a particular borrower.

Some P2P lenders specialise in loans to individuals consumers—for example Ratesetter, others such as Funding Circle focus on lending to small or micro businesses, while a third group such as Zopa are players, or plan to be, in both markets.

Crowdfunding is also an online marketplace, which also aggregates many investors (often for very small amounts) to provide funds for investment in a particular project, often enabling investments in shares and other instruments. However, crowdfunding can also be used to fund projects with a social or environmental purpose, and can be seen as a form of social impact investing. For example, Buzzbnk is a peer-to-peer lending platform for social enterprises, charities and community enterprise.

The importance of diversity

342. A key theme to emerge from our inquiry was the current lack of diversity in the UK retail banking market and the importance of creating a more diverse market. Many of our witnesses told us that a more diverse market would play a role in improving standards in the wider industry. They also stressed a number of other reasons why greater diversity was important. For example, Tony Greenham told us that we needed to differentiate between “competition and choice”, which he told us were “not necessarily the same thing”. He argued that “diversity of banking institutions “gives an additional, genuine choice to potential consumers”. He lamented the lack of diversity in the UK market:

That [diversity] does not exist if you simply have a series of very similar banks competing, which is effectively the situation we have had for some while in the UK. We have by international standards a remarkably homogenous banking industry: very concentrated, large national players, very few local banks if any; and they all tend to prioritise chasing the same customers

Mr Greenham explained how diversity in the UK retail market was reduced over time:

We have lost that sector [mutuals] as a result of various developments, including the demutualisation of the building societies and the gathering-up of all the local trustee savings banks into one national bank that was then taken over by Lloyds. We have

lost that diversity. In other countries they have tended to protect these mutual sectors in one way or another.⁶⁹⁶

He went on to expand on how the UK's lack of diversity contrasted sharply with elsewhere:

There are co-operative banks, which are particularly prevalent in Europe. We have one co-operative bank, but it is national one [...] There are credit unions [...] which, particularly in North America, have significant market shares. There are public savings banks, which are the models we see in Switzerland and Germany but also elsewhere. And you also have, in the US and in this country, the community development finance institutions [...] In addition to these four forms, we of course now have new models [...] of crowd funding and peer-to-peer. We would argue that the more of those you have in your banking system, the healthier it is for consumers and for the economy.⁶⁹⁷

Mr Greenham ended by telling us that “it should be an explicit objective of banking policy in this country to encourage a much greater degree of diversity of provision across all of those potentially different forms of bank”.⁶⁹⁸ This position was echoed by the Finance Innovation Lab who said that “the Bank of England and the Prudential Regulation Authority should have a statutory duty to achieving greater diversity of providers, along with more new entrants and competition, within and with the existing banking system”.⁶⁹⁹

343. Diversity of provision in the retail banking market matters. The Commission sees value not just from more new banks with orthodox business models, but also from alternative providers. Diversity of provision can increase competition and choice for consumers and make the financial system more robust by broadening the range of business models in the market. The UK retail market lacks diversity when compared to other economies, and this has served to reduce both competition and choice to the obvious detriment of consumers. The Commission strongly supports moves to create a more diverse retail market. However, the Commission is not persuaded of the case for adding another ‘have regard’ duty for the Financial Conduct Authority at this time, beyond the current competition and access provisions. Instead, the regulator should ensure that other forms of provision are not put at a disadvantage. This should be reviewed by the FCA within four years and be the subject of a report to Parliament. The PRA will need to support the FCA in this wherever possible, by avoiding prudential requirements which deter alternative business models emerging or place them at a competitive disadvantage.

Peer-to-peer and the rise of the internet

344. The Peer to Peer Finance Association, the trade body for the sector and whose members represent 90 per cent of the peer-to-peer lending market, stressed the importance

696 Q 2977 [Tony Greenham]

697 Q 2976 [Tony Greenham]

698 *Ibid.*

699 F Ev 89

of technology as a catalyst for the growth of such firms and as a force for increased competition in the retail market:

The widespread availability of digital broadband technology is allowing the cost effective development and distribution of new sorts of financial services products to retail consumers. Peer to Peer Lending (P2P) is a good example of a product that couldn't exist before the arrival of the internet.⁷⁰⁰

Giles Andrews was just one of many who described the internet to us as “the classic disruptive technology” which was a force for increased competition. He asked:

What does an incumbent do when faced with a disruptive entrant? To compete with a disruptive entrant, they have to discount their pricing significantly across the board. They cannot just compete with the customers who might otherwise go to the disruptive entrant. Often the most sensible thing for them to do is to ignore it, because it might go away. It is classic behaviour [...] typically the incumbents do not respond, because it is uneconomic for them to do so until such a point where they have to respond, by which time they have lost some momentum.⁷⁰¹

345. We heard that the UK was a market leader in this field. Just one of many organisations to emphasise this was RateSetter, who said that “it should be noted and appreciated that the UK has embraced the innovation of P2P (unlike other advanced economies which have blockages preventing such innovation)”.⁷⁰²

346. Firms such as Zopa and RateSetter told us that they saw themselves as competing with the mainstream banks, but often across a “narrow product set”.⁷⁰³ Others told us that, in addition to competing with banks, they were also filling gaps in the market, especially in terms of finance for smaller enterprises. For example, the Peer to Peer Association told us that the growth of such firms was a direct challenge to the large banks given that “Peer to Peer Lending now offers a way for consumers with money available to put that money to use in the real economy and get a reasonable return, and for consumers or small businesses who need a fixed term loan to borrow that money and pay it back”.⁷⁰⁴ This sentiment was echoed by Zopa—which was launched in 2005 as the first peer-to-peer lending business, specialising in loans to consumers—who said that it provided “competition to the banks by offering very competitive lending rates and consumer friendly terms which enabled them to compete “directly with the banks in a narrow product set”.⁷⁰⁵ This theme, that peer-to-peer lenders were more efficient than traditional lenders, was one that surfaced time and time again. For example, RateSetter argued that:

By offering rates which are amongst the best value in the personal loan market (as seen on all the ‘price comparison’ sites), we have kept the market open and

700 F Ev 52, 57

701 Q 2966

702 F Ev 60

703 F Ev 52, 59

704 F Ev 57

705 F Ev 53

competitive at a time when established lenders have reduced their exposure (to focus on more core lending such as corporate and mortgages). Had P2P not kept a competitive offering in personal loans, their availability and cost would be significantly worse for consumers.⁷⁰⁶

RateSetter described itself as having “reduced” “the gap between what savers can earn and what borrowers can pay”, but acknowledged “P2P companies are still middlemen, just like a bank ultimately is: they [P2P] are just ‘thinner’ middlemen”.⁷⁰⁷

347. Crowdbnk stressed how their internet-driven business model allowed them to:

Introduce much lower cost, and more transparent, retail financial services than traditional service providers. Relying solely on internet and mobile technology enables new entrants to market their services, process transactions and enable secure consumer access to transaction data for a fraction of the cost of traditional firms with legacy IT systems and physical branches.⁷⁰⁸

Funding Circle told us that they were “faster and more efficient than a bank loan. On average it takes 12 days for a business to gain finance through Funding Circle, compared to 15-20 weeks with a bank”.⁷⁰⁹ Another advantage cited by such firms was a greater focus on customer service. For example, Giles Andrews told us that his firm combined the use of technology with what he described as a “much more human side to what we do”. Mr Andrews told us that this was particularly relevant to the SME sector:

Because banks are unable to make human decisions to lend, when humans make the best decisions on lending to SMEs. someone goes to kick tyres or count parts in a warehouse. We have re-introduced quite a lot of that, which is very economical for us to do at scale. It involves a simple phone call, where we can establish, we think better than any algorithm can, the likelihood of the person repaying.⁷¹⁰

348. Funding Circle described themselves as enabling retail investors and savers to “lend directly to businesses”, thereby “side-stepping the banks”. They argued that they were “helping to fill the void created by the retrenchment of traditional providers to lend to small businesses”.⁷¹¹ This point was also stressed by Crowdbnk who told us that they were helping to “fill a significant funding gap currently ignored by the major retail banks and traditional investment firms. We conservatively estimate that there are approximately 25,000 viable small businesses that fail in the UK every year because of a lack of growth funding and the unwillingness of banks and existing investment firms to provide financing”.⁷¹²

706 F Ev 59

707 *Ibid.*

708 F Ev 92

709 F Ev 69

710 Q 2961

711 F Ev 68

712 F Ev 92

349. Abundance, a crowdfunding platform, that is an online retail investment platform which allows people to invest directly in UK renewable energy projects, infrastructure and businesses, also told us that they “compete directly with UK banks both in terms of the provision of finance to UK businesses and infrastructure and in the provision of investment products for retail investors”. However, they also saw themselves as “reaching the parts of the economy which universal banks cannot reach or no longer feel it is economic within their legacy business models to reach”, and thereby acted to “fill the funding gap” which were “particularly acute for community scale independent producers”. Abundance also stressed the benefits to consumers from an investor perspective of the growth of organisations such as their own which enabled retail investors to tap into a far wider range of asset classes:

The advantages to retail investors of gaining access to these projects are significant. Until the launch of Abundance in April 2012, it was only possible to access the returns from renewable energy assets via schemes targeted and incentivised for so called high net worth investors with minimum of £10k or more to invest.⁷¹³

350. 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.

Bringing alternative providers into the regulatory orbit

351. We examined the barriers facing new alternative providers trying to enter or grow in the market. The Financial Innovation Lab listed four barriers to a more diverse retail market: “regulatory barriers to new entrants, unfair market advantages of incumbent banks, lack of consumer awareness and trust of alternatives to existing banks, and poor engagement between regulators and financial innovators with new business models”.⁷¹⁴ Some of these barriers—for example, the process of regulatory approval, rules around capital and liquidity, the “entrenched advantages of incumbent large banks”, “the implicit state subsidy they receive”—were common to all new entrants, but others were specific to alternative providers.

352. One issue, frequently raised in written evidence from alternative providers, was regulation. The regulation of peer-to-peer lenders and crowdfunding platforms is at a nascent stage, with some parts of the sector already subject to regulation while others are in the process of being brought into the regulatory orbit. Peer-to-peer lenders, for example, “are currently unregulated other by the OFT for the consumer credit part of their

713 F Ev 46-47

714 F Ev 89

business”⁷¹⁵, although the Treasury recently announced that peer-to-peer lenders would be brought into the regulatory framework. This move was welcomed by the industry.

353. The Peer to Peer Finance Association told us that the industry welcomed the “recent announcement by the Treasury that peer-to-peer lending will in future be formally regulated”.⁷¹⁶ This sentiment was echoed by RateSetter who told us that being regulated was important “because it would boost consumer confidence in the product, while reducing the risk of consumer detriment should a less professional or even rogue player enter the market”.⁷¹⁷ Funding Circle concurred, stating that “formal regulation will help to raise awareness and provide additional levels of credibility for the wider peer-to-peer lending industry”.⁷¹⁸ RateSetter outlined yet another benefit to coming into the regulatory fold boosting “the confidence of intermediaries such as independent financial advisors who see the value in P2P but are reluctant to advise their customers to consider it purely on the basis that it is unregulated”.⁷¹⁹

354. However, industry participants cautioned that regulation must be “appropriate and proportionate”.⁷²⁰ The Peer to Peer Finance Association said that they were:

Concerned to ensure, however, that the new regime established by the FCA is truly proportionate and risk based. A risk averse backward looking regulator who did not fully sign up to the dynamic market benefits of promoting competition could construct a regime that was so cumbersome and costly that innovative new businesses would be stymied [...]

Unless the right regulatory balance is struck, regulation could prevent UK consumers from benefitting from the simple, good deal products available now.⁷²¹

They argued that a different form of regulation was more suitable because such firms were “neither ‘bank’, in that they do not take deposits, arrange payments and take counterparty risk in the way a bank does, nor are they collective investment schemes or other investment products”. Instead, they argued in favour of a regulatory regime which “accepts that full transparency and clarity of the deal to consumers is consumers’ best protection”.⁷²²

355. A related issue raised by alternative providers was the perceived lack of regulatory understanding of unorthodox business models, combined with a tendency for regulators to focus on the big banks at the expense of smaller players. We received a number of submissions which stressed the lack of understanding of their business model amongst regulators as a significant barrier to starting up. The Finance Innovation Lab summarised the problem as follows:

715 F Ev 58

716 *Ibid.*

717 F Ev 60

718 F Ev 70

719 F Ev 60

720 *Ibid.*

721 F Ev 58

722 *Ibid.*

Existing financial service regulation is set up to handle business models from the status quo. By definition, any innovations will be harder for regulators to address [...]

The sheer size of big banks has inevitably led to policymakers and regulators focussing their limited resources on those players, thus squeezing out the time to engage with innovation. This creates a vicious circle where the expertise of regulators is concentrated over time onto certain types of bank and financial risks, making it even harder for new entrants to be heard or understood.⁷²³

356. 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.

357. We also took evidence on other issues which needed to be addressed in order to create a more level playing field between the incumbent banks and alternative providers. The issue of tax arose frequently. For example, the Financial Innovation Lab told us that “the way the tax system treats products from mainstream banks compared to new innovations places a distortion on the savings market”.⁷²⁴ RateSetter explained that this was because, while “banks are able to attract funds from many tax-advantaged sources such as SIPPs and ISAs”, this was not the case with respect to peer-to-peer:

While it appears legally possible to include P2P in SIPPs, some SIPP providers seem reluctant to make the necessary updates to their systems. It is not possible to include P2P in an ISA which sets P2P at a significant disadvantage to banks. The ability for consumers to place their P2P funds in an ISA would make a massive difference (and is something our customers ask for every day).⁷²⁵

This point was also stressed by Abundance, who argued “for the extension of ISA rules to create a more level playing field for so called alternative finance companies”.⁷²⁶

358. Giles Andrews also explained that lenders through the P2P platforms were disadvantaged compared to banks because they were taxed on the advertised rate of interest rather than the return received. If P2P lenders were given the same tax advantages as banks then lenders would be able to move further along the risk spectrum to offer services to a broader range of clients. More specifically, Mr Andrews explained that:

723 F Ev 90

724 *Ibid.*

725 *Ibid.*

726 F Ev 47

If Zopa lends currently in a very prime world, where there are very low credit losses, our lenders have to pay tax on the interest they have received gross. If a lender lends money at 7%, suffers a 0.5% credit loss and makes a net 6.5%, he pays tax on 7% and then suffers his credit loss afterwards, and the fact that he suffered a credit loss after tax does not really matter.

If you then move that into a world of more inclusive lending—economically, we simply cannot do that, because of this tax incentive—and lend money at 15%, with an expected credit loss of 8%, the lender would pay tax on the gross amount of 15%. A reasonably high proportion of our lenders are higher-rate taxpayers, so they would pay tax at 6%. They would then suffer predicted credit losses of 7% or 8%, and they would be left with nothing. The tax incentive, which is in statute—we are talking to the Treasury, as you might imagine, about trying to amend it—is very clear: because these are private individuals earning interest, they have to pay tax on the gross amount they are not allowed to offset. In terms of reasonable expenses to offset against that, a credit loss is a pretty reasonable expense to offset against an income stream.

Mr Andrews added that, until this was “changed”, “a business like ours will never be able to undertake inclusive lending in disadvantaged areas. We have a huge amount of interest in doing so from our lenders, but it makes no sense for them to do so”.

359. The Commission recommends that the Treasury examine the tax arrangements and incentives in place for peer-to-peer lenders and crowdfunding firms compared with their competitors. A level playing field between mainstream banks and investment firms and alternative providers is required.

Enabling customer choice

Introduction

360. Freedom of switching between providers is an important indicator of the effectiveness of a market. John Fingleton told us that switching was one of the “two fundamental drivers of competition”, alongside market entry.⁷²⁷ Sir Donald Cruickshank explained why switching was important to achieving high banking standards:

the person who is managing a division of a bank [...] has got to worry on a Friday night that he might have lost a significant number of his customers by Monday because of something he did on Thursday night, such as if nobody could transfer money or get paid [...] He or she has got to believe that there is a significant risk that, if that happens, a significant number of his or her customers will have gone by Monday morning.⁷²⁸

727 Q 2322

728 Q 174

361. Switching rates are currently very low. The OFT cited estimates that 3 per cent of personal current account holders switched their main account in 2012.⁷²⁹ Martin Wheatley explained the two main explanations for low switching rates:

there is still a risk. People have all heard horror stories of how payments have not been made or critical payments have been dropped, so they have concerns about how safe it is. More importantly, it is not clear that there is another offering that is significantly better than your current bank.⁷³⁰

Craig Donaldson said that “it is not difficult to switch [...] it is the perception [...] that it is difficult to switch that is the issue”.⁷³¹

362. A new seven-day switching service (sometimes referred to as a redirection service) is to be introduced in September 2013. It is the result of the Payments Council taking forward a recommendation by the ICB.⁷³² The service should reduce the amount of time it takes to switch an account from an average 18 days at present to seven working days. It includes various measures to reduce disruption for customers in switching.⁷³³

363. Various more radical alternatives to the seven-day switching service were suggested to us in evidence. These options tend to fit on a scale of reduced switching times and increased central storing of information. This scale encompasses the overlapping concepts of full account portability and a common utility platform. These are considered below.

Common utility platform

364. A common utility platform is a single shared core banking infrastructure, which all banks could use. VocaLink identified information that might be held by a common utility platform:

A central database of standardised customer credentials that meet “Know Your Customer” (KYC) requirements, with a ‘portable’ identifier. This would also deliver a standardised level of KYC across the industry;

A central database of payment mandates for each account, to allow customers to move banks easily and also allow payments to continue flowing in the event of a bank failure.

A central database of end-of-day balances for each account, to further facilitate customers moving banks, to aid resolution of a failed bank and to facilitate payments under the Financial Services Compensation Scheme.⁷³⁴

⁷²⁹ Office of Fair Trading, *Review of the personal current account market*, January 2013, para 6.20

⁷³⁰ Q 242

⁷³¹ FQ 34

⁷³² Independent Commission on Banking, Final Report, September 2011

⁷³³ Payments Council, *Improving current account switching*, October 2011, www.paymentscouncil.org.uk

⁷³⁴ F Ev 116

Andy Haldane explained the potential competition benefits of holding such information in a common utility platform:

I am personally attracted to the notion of customer account details being stored in some central utility-type function. That information is effectively a public good and should be stored as a public good. Banks generally would then compete to plug and play into that central utility. That will lower barriers to entry. The difficulty of current account switch is currently a barrier. It would make the process of searching across deposit account offerings that much easier.⁷³⁵

Andrea Leadsom MP wrote that the reduction in barriers to entry resulting from a platform would “be a boost to challenger banks and take away the unfair advantage enjoyed by long-established clearers”.⁷³⁶

365. A number of witnesses, including Bank of England officials, stressed the financial stability and resolution benefits which could result from adopting a common utility platform. These benefits would crucially not accrue with 7-day switching or account portability. For example, Sir Mervyn King explained the financial stability benefits of a platform, particularly in terms of the resolution of failed banks:

One of the key elements of resolution, even in simple cases, is how you handle the transfer of retail depositors from the bank that gone into resolution possibly into a new bank between Friday night and Monday morning. A mechanism in which that was simple and straightforward would help. So I am in favour of the principle.⁷³⁷

Mr Haldane said that the creation of a common utility platform would “safeguard the safety, security and resilience of the payments mechanism”.⁷³⁸ Other potential benefits cited included that it would provide impetus to update antiquated bank IT systems,⁷³⁹ and that it would reduce opportunities for fraud.⁷⁴⁰ Mr Haldane told us such a platform was “well within the compass of technology”.⁷⁴¹ There was agreement, amongst both advocates and opponents of a common platform, including VocaLink,⁷⁴² Lloyds Banking Group,⁷⁴³ Tusmor⁷⁴⁴ and Intellect⁷⁴⁵ that a common platform was technically feasible.

366. We heard several criticisms of a potential common utility platform. António Horta-Osório’s noted “the increasing systemic risk” if banks were to share IT platforms, warning of reduced incentives to innovate to compete on technology and that it would be “highly

735 Q 593

736 Ev 1202

737 Q 1180

738 EQ 158

739 Q 605

740 FQ 115

741 EQ 158

742 FQ 164

743 Ev 1227

744 F Ev 73

745 Ev 1137

costly and will take a long time to implement”.⁷⁴⁶ Andy Haldane acknowledged potential overreliance on a single geographical site and the civil liberties implications of centrally holding customer information.⁷⁴⁷ Lloyds Banking Group argued that a common utility platform would be desirable if UK banking was being started from “a blank piece of paper”. However, they argued, the UK has well established payments systems and “to deliver a utility infrastructure now would be akin to flattening the whole of London to rebuild it as a more efficient grid-based Manhattan style city”.⁷⁴⁸ David Yates, the CEO of VocaLink, explained the technical difficulties in moving to a common platform:

It is an enormous technical work-out and it would be quite invasive to the banks’ own operations to do even the first step on that journey. It is not to say it should not be done but it would be a big work-out because you would effectively be changing a core of data sets that drive all payments in and out of the bank network. It would need an immense amount of co-ordination and would take quite a long time. I guess the question then becomes: what is the opportunity cost of doing that versus doing some other pieces of innovation within the market?⁷⁴⁹

Lloyds Banking Group drew attention to the danger that, by the time the platform was created and current accounts had been migrated to it, “infrastructure would also be at risk of being obsolete”.⁷⁵⁰

Account portability

367. The phrase “account portability” is sometimes used interchangeably with the “common utility platform”.⁷⁵¹ It is also used to describe two broad and related alternatives to the redirection service that are less radical than the creation of a platform:

- account number portability in which a customer’s sort code and account number would not change when the customer changed banks, thereby avoiding the need to change any payment or credit instructions; and
- account portability through the creation of an “alias database” and assigning unique and permanent identifier to each account, which would facilitate rapid switching without the need to retain the same account number and sort code.

368. Andrea Leadsom MP argued that a system based on a unique identifier was not, unlike full account number portability, “eye-wateringly expensive”,⁷⁵² and would achieve very similar goals in a “minimalist way”.⁷⁵³ She also explained that it would overcome a crucial practical objection to account number portability, in that you could continue to

746 Q 3516

747 EQ 163

748 Ev 1231

749 FQ 164

750 Ev 1232

751 For example, Ev 1198

752 FQ 120

753 FQ 110

make international remittances, which rely on sort codes being unique to individual banks.⁷⁵⁴ Several witnesses, including the Chancellor of the Exchequer⁷⁵⁵ and John Fingleton,⁷⁵⁶ argued that retaining a particular account number was not as important to consumers as, say, retaining a phone number. Benny Higgins, CEO of Tesco Bank, added “most people would not be able to tell you their bank account number”.⁷⁵⁷

369. Currently, when a consumer or small business switches their account the costs of making administrative changes are imposed on a large number of other parts of the economy. Employers have to change their payroll details, small and large businesses have to change regular payments and government departments and local councils have to change details for the payment of benefits. The costs of these changes will not be removed by the seven working day switching service. By removing the need for these administrative changes, account portability also has important administrative savings for consumers, small and large businesses and Government.

370. Jayne-Anne Gadhia told us that the deficit of competition in retail banking was such that seven-day switching was insufficient and it was necessary “to move to full account portability so that a broader range of banks can participate on a level playing field”.⁷⁵⁸ Andrea Leadsom MP suggested that “seven-day switching be part of the journey towards full-account portability”:

It should be supported to provide a quick-fix to some of the problems. And the government should announce now the intention to introduce full account portability with a long lead time, to tie in with the timetable for the retail ring fence.⁷⁵⁹

371. Lloyds Banking Group expressed concern that the mechanism for linking old and new account details following a switch would concentrate risk in payments systems:

Considering there are around 300 million separate accounts in the UK, and over 120 million transactions daily through these accounts, the new routing table would have a vital but risky role to play.⁷⁶⁰

Lloyds also argued that the technology and infrastructure required to achieve account portability on a unique identifier basis would be “incredibly complex” and tantamount to a utility platform.⁷⁶¹ Ben Wilson, Associate Director, Financial Services Programmes, Intellect, said that “that it is probably the case that a central utility would provide the best means of account portability”.⁷⁶²

754 *Ibid.*

755 Q 4359

756 Q 2340

757 FQ 87

758 FQ 37

759 Ev 1198

760 Ev 1230

761 F Ev 42

762 Q 3163

Seven-day switching service

372. The ICB looked at the case for 7-day switching versus account portability. They did not dismiss the case for account portability, but instead acknowledged that “there may be a case for account number portability in due course, but the redirection service would be a cost-effective first step”:

If it does not achieve its aims, there could be a strong case, depending on cost, for full account number portability to be introduced (potentially through use of an alias database).⁷⁶³

The ICB said that once implemented “the FCA should assess whether it is delivering enough of an increase in willingness to switch to lead to effective competitive tension”. If not, then “the incremental costs and benefits of account number portability should be considered”.⁷⁶⁴ Sir John Vickers explained to us the rationale behind the ICB’s decision:

We did consider the case for moving to full account number portability. However, we thought that the costs of that, even though we didn’t believe all the numbers put to us, were likely to be substantially greater, and it was not clear—without seeing how the redirection service goes—what the incremental benefit of portability would be. So it seems to me that a perfectly sensible approach is to get the redirection service in place; there are other related things about payment systems reform in general. Let us see how that redirection service goes and then come back to number portability.⁷⁶⁵

Sir John said that he thought there was a “good chance” that seven-day switching “will change behaviour and consumer confidence around the switching process”.⁷⁶⁶

373. Proponents of the seven-day switching service argue that it will successfully address many of the key reasons why consumers decide not to switch. Adrian Kamellard from the Payments Council said that new seven-day service would address concerns that switching is difficult:

What makes the difference, and is the critical thing, is that everything is characterised as being simple and hassle-free. The key thing for the customer is that once you have told your new bank that you want to change, you need to be able to sit back and do nothing more.⁷⁶⁷

António Horta-Osório told us that the redirection service would remove “uncertainty and risks” in the switching process.⁷⁶⁸ Benny Higgins also supported seven-day switching, arguing that, if well executed, it would achieve the benefits of account portability:

let us prioritise what will make this market much more competitive. Making the switching service seamless—so that customers can go into it knowing reliably that

⁷⁶³ Independent Commission on Banking, Final Report, September 2011, para 8.60

⁷⁶⁴ *Ibid.*

⁷⁶⁵ Q 768

⁷⁶⁶ *Ibid.*

⁷⁶⁷ Q 3129

⁷⁶⁸ Q 3402

they will not have difficulty with direct debits and standing orders—is the issue. I believe that the switching service, if executed well, will achieve that, and I do not think that portability would bring any more.⁷⁶⁹

Mike Dailly of the Financial Services Consumer Panel was similarly enthusiastic:

It is going to be much, much better than what we have at the moment. It will cure all the problems we know that put people off in the first place—direct debits going wonky. All that sort of stuff is going to get fixed, and we see this as being really good.

Tusmor, while supportive of 7-day switching, questioned why the 7-day time period could not be reduced further: “we believe the new 7-day switching process could happen much faster than seven days. Indeed it could and should be an overnight process”.⁷⁷⁰

374. Several witnesses confirmed the experience of the Netherlands, where a system very similar to the 7-day switching service had been introduced and was working well. Disappointingly, so far, there has been little movement in switching rates, which remained very low.

375. Clive Maxwell said that, properly publicised, the seven-day service “could make a big difference”:

Having a formal commitment around seven days and making sure that the rate of errors and so on drops markedly will be very important. Publicising the way it operates will be important.⁷⁷¹

Both Clare Spottiswoode and Adrian Kamellard told us that a substantial public information and promotion campaign was planned.⁷⁷²

Switching fee

376. We also examined the issue of the switching fee under the 7-day switching service and, in particular, who would pay the fee. The cost of introducing the Central Account Switching Service (CASS) is currently estimated at around £750m. The majority of this cost will fall on individual institutions, but approximately £100m will be incurred at the centre. Of this £100m of central costs, around four-fifths is to be recouped via a per switch transaction fee which would be contributed by participating users of the service. This fee could be structured in a variety of ways, for example:

- the bank acquiring a customer pays the entire switch fee;
- the bank losing the customer pays the entire fee; or
- the per switch fee is shared between the two institutions.

769 FQ 87

770 F Ev 80

771 Q 3080

772 Qq 2338, 3130

377. The Payments Council told us that “originally” their Board “had endorsed the working principle that this cost should be recovered through a per switch charge paid by the institution acquiring the customer during the initial period of live operation”. However, they went on to tell us that:

As the development and implementation of the service progressed, that working principle has been challenged and is now under review. To ensure a fair and considered approach is taken in this, we have commissioned an independent consultancy to make recommendations regarding the most appropriate model or models for the recovery of these costs. The independent review is looking at two aspects: what costs should constitute a per switch fee and who should pay it.

The review is due to conclude in June 2013.

378. The Payments Council’s original decision to endorse an acquirer pays model had caused some concern about whether it would disadvantage new and smaller banks hoping to win market share. In December 2012, Benny Higgins, CEO of Tesco bank, wrote to us stating that:

If executed in a fair and accessible way the Central Account Switching Service will enable new entrants and existing current account providers to compete for customers on a more level playing field. This will enhance the market and allow customers to vote with their feet and encourage all providers to offer competitive and innovative products.⁷⁷³

He wanted to see a switching fee adopted which was “affordable, appropriate and shared by both the old and new bank regardless of whether a customer’s switch is full or partial”.⁷⁷⁴ However, Mr Higgins went on to express concern that the Payments Council’s apparent preference, at the time he wrote to us, for adopting an acquirer pays model for the new switching service “may deter new entrants from entering the market, lead them to opt out of CASS due to the high cost or pass this cost on to customers to ensure they can offer the service”.⁷⁷⁵

379. The ICB which initially proposed a new switching service had been clear that such a service “should be introduced in a way that does not impose disproportionate costs on new entrants and banks that access the payments system through agency agreements”. It went on to state that “in particular, small banks/building societies and small business direct debit originators should not be penalised by this move to improve the switching system”. The OFT, in their review of the personal current account market, also stressed this point”:

the OFT would have concerns over fees from this service being borne wholly by the new bank unless a very clear justification for this approach can be provided that takes into account the impact of this approach on competition in the market and barriers to entry

773 F Ev 139

774 F Ev 140

775 F Ev 139

380. The ICB, the OFT and others have been clear that the new switching service and the per-switch fee should not impose disproportionate costs on new entrants or small banks. The Commission concurs and finds it difficult to envisage any circumstance in which it would be appropriate for the per-switch fee to be borne wholly by either the new bank acquiring the customer or by the bank losing the customer.

Assessing the options

381. An important concern articulated by several witnesses was that the proposals for radical reform of the switching process are intuitively appealing but have not been fully developed. Professor Robin Bloomfield said “what you have before you are a number of vague visions and some speculation about common platforms”.⁷⁷⁶ António Horta-Osório guarded against the “conceptual attractiveness” of a common platform clouding its practical problems⁷⁷⁷, a view echoed by Craig Donaldson:

We need to be careful that the intellectual does not take us so far that we forget about the operational requirement to do something now.⁷⁷⁸

Andy Haldane conceded that “the precise model needs to be articulated” and that “those should all be evaluated properly”.⁷⁷⁹ Sir John Vickers told us:

I can see its appeal in the abstract, but being practical and realistic about it, and thinking of time scales, no one can know at this point whether that is the right kind of solution or the cost-benefit analysis of getting there, particularly before we know how redirection works out.⁷⁸⁰

382. Several witnesses guarded against taking industry warnings of huge costs at face value. Referring to account portability, Diane Coyle said:

Any industry will tell you that it is much too costly and complex to do, and of course you have to think about what the benefits are. I think the benefits of switching and more competition in the industry will be very large indeed.⁷⁸¹

Clive Maxwell, when asked about the costs and complexity of account portability, told us that he had “not seen [...] a serious piece of analysis that sets out those costs”. He said that the OFT had “pressed the Payments Council to do that most recently and I would like to see the numbers setting out those costs and benefits”.⁷⁸² Sir Donald Cruickshank argued that a regulator ought to estimate the costs of the various switching options:

If it concluded at the end of three or four years that there was indeed no case for number portability, that the costs outweighed the benefits, so be it. There would be

776 Q 3168

777 Q 3516

778 FQ 7

779 EQ 158

780 Q 2612

781 Q 2334

782 Q 3802

amendments to the present regime, and on we would go with something different. [...] However, if we do not make that investment, we will never know, because the banks have the monopoly of the information here.⁷⁸³

383. In its 2011 Report, *Competition and Choice in Retail Banking*, the Treasury Committee recommended that “an independent technical study should be done into how account portability could operate”.⁷⁸⁴ This study has yet to be commissioned, still less completed. Andy Haldane called for “a full, objective, arm's-length quantitative evaluation of the costs and benefits of the [common utility platform] proposal, which is something that, so far, we have singularly not had”.⁷⁸⁵ The Governor of the Bank of England argued against putting the regulator in charge of such a study, but instead advocated giving it to “a group of people who [...] understand how to operate systems of this kind and get them to do an appraisal”.⁷⁸⁶

384. The Commission welcomes the introduction of the seven-day switching service. It should improve the switching process for consumers and increase the level of competition in the current account market. We consider it vital that the launch of service be fully publicised and that any practical problems that emerge be addressed with urgency. We regret the fact that neither the Government nor the Payments Council have established benchmarks to measure the impact of the new service.

385. A common utility platform is an intellectually appealing idea and has the potential to introduce much greater competition into the market than a seven-day switching service. The benefits of a common utility platform include improving competition through significantly faster switching times and reducing the risk that consumers will encounter administrative problems as a result of switching their bank account provider. Financial stability benefits, supporting the FPC's objectives, that could result from the implementation of a common utility platform include raising the general levels of transparency in the money system, improving bank resolvability in the case of bank failure and encouraging banks to make much needed investment into their patchy and outdated in-house IT systems. However, the idea is insufficiently developed to be recommended by the Commission. It is impossible to make a judgement about its merits or about related proposals for account portability without a much clearer idea about the cost, benefits and the technical feasibility of each. It is also extremely disappointing that no independent technical study of account portability has been conducted, despite a request by the Treasury Committee over two years ago. The vagueness of the proposals put to the Commission is disappointing.

386. We were concerned that the largest banks object very strongly to bank account portability. While there is some evidence that individual banks may have done some work on the costs of account portability, this does not appear to have been accompanied by a comprehensive consideration of all the benefits of portability. This

783 Q 177

784 Treasury Committee, Ninth Report of Session 2010–11, *Competition and choice in retail banking*, HC 612, para 121

785 Q 605

786 Q 1180

gives the impression that their objections are instinctive and, arguably, that they are opposed to any reform that could encourage competition. The lack of an independent regulator, a matter being considered by the Government, may help to explain why no real progress has been made on this matter.

387. The Commission recommends that the Government immediately initiate an independent study of the technical feasibility, costs and benefits of the full range of options for reform in this area. Such a study must be conducted by an independent body rather than one linked to the industry. To this end, the Commission recommends that the Treasury establish an independent panel of experts to consult widely and report on portability. The panel should not have current industry representatives amongst its membership. Membership of the panel should be drawn from banking IT specialists, retail banking competition experts, economists, representatives of retail consumers and small businesses and resolution specialists. It should report within 6 months of its establishment on switching and within 12 months on other issues. The panel, as part of its work, should examine the implications of the central storage of consumer data, implicit in the common utility platform proposal. It should also examine the scope for reducing downwards from seven days the time it will take to switch under the new switching service.

A market investigation reference

388. The main driver of consolidation and increased concentration within the sector in the aftermath of the financial crisis has been a significant increase in mergers as well as the exit from the UK market of some overseas operators. In a recent speech, the Chancellor of the Exchequer said:

One of the prices we're paying for the financial crisis is that our banking sector is now dominated by a few big banks.

It verges on an oligopoly.

75 per cent of all personal current accounts are in the hands of just four companies.⁷⁸⁷

389. Of these mergers, the largest by far was the merger of Lloyds TSB and HBOS. The combined entity Lloyds Banking Group is now the market leader, often by a considerable margin, in most segments of the retail market. Indeed, the OFT's 2010 *Review of barriers to entry, expansion and exit in retail banking* found that the combined group had the largest market share in the personal current account market, the mortgage market, the savings market—where its market share was twice as large as that of its nearest rival, Santander—and the unsecured personal loan market.⁷⁸⁸ The OFT in its October 2008 report to the then Secretary of State on the merger expressed some concern about the potential impact on competition. It concluded that:

787 HM Treasury, Speech on the Reform of Banking by the Chancellor of the Exchequer, Rt Hon George Osborne MP, 4 February 2013

788 Office of Fair Trading, *Review of barriers to entry, expansion and exit in retail banking*, November 2010, pp35-57,

- there is a realistic prospect that the anticipated merger will result in a substantial lessening of competition in relation to personal current accounts (PCAs), banking services for small and medium-sized enterprises (SMEs) and mortgages;
- the OFT's concerns on PCAs and mortgages are at the national (Great Britain) level, while its concerns on SME banking services are focused on Scotland. In addition, the OFT cannot exclude competition concerns arising at the local level in relation to PCAs and SME banking services;
- no further competition concerns are considered to arise in relation to the other identified overlaps between the parties in retail banking (savings, wealth management, personal loans, credit cards and pensions), corporate banking (banking services to large corporations, asset finance/fleet car hire) and insurance (PPI, life, general); and
- in the absence of any offer of remedies from the parties, it would not be appropriate to deal with the competition concerns arising from the merger by way of undertakings in lieu of reference to the Competition Commission.⁷⁸⁹

390. Both Lloyds Banking Group and RBS received Government capital support during the financial crisis. As a condition of this state-aid, both firms were required by the EU to make divestments. LBG's restructuring plan (known colloquially as Project Verde) consisted of the divestment of a retail banking business with at least 600 branches, a 4.6 per cent share of the personal current account market in the UK and up to 19 per cent of the Group's mortgage assets.⁷⁹⁰ RBS was to dispose of the Royal Bank of Scotland branch-based business in England and Wales, the NatWest branch network in Scotland, its Direct SME customer base and certain mid-corporate customers across the UK, which would involve the divestment of 318 branches (known colloquially as Rainbow).⁷⁹¹

391. The ICB in their final report wrote of how the Lloyds Banking Group and RBS state aid divestitures "will reduce concentration to some extent".⁷⁹² To date, neither divestment has yet to take place. The proposed RBS divestment to Santander fell through in October 2012. Ms Ana P Botin, Chief Executive of Santander UK, explained the reason for withdrawing from the deal as follows:

The agreement reached in August 2010 between Santander UK and RBS for Santander UK to acquire the businesses was originally scheduled to complete by end 2011. In August 2011, this was extended to a new target completion date of Q4 2012. However, an independent report commissioned by both parties, estimated completion in Q2–Q3 2014 four years after the original agreement was signed and a delay of almost three years.

789 Office of Fair Trading, *Anticipated acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform*, 24 October 2008

790 Independent Commission on Banking, Final Report, September 2011, p207

791 See European Commission, *Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme*, ec.europa.eu, 14 December 2009, para 73

792 Independent Commission on Banking, Final Report, September 2011, p167

Accordingly, the Board of Santander UK decided on Thursday 11 October that it would not agree to a further extension of the timeline for the deal.⁷⁹³

392. The Lloyds divestment (Project Verde) to the Co-operative Group also subsequently collapsed in April 2013. Peter Marks, Group Chief Executive of The Co-operative Group justified the Group's withdrawal on the grounds of the complexity of the Verde transaction and against a "backdrop of the current economic environment, the worsened outlook for economic growth and the increasing regulatory requirements on the financial services sector in general".⁷⁹⁴

393. Lloyds has now signalled that its lead option for the disposal of Verde is via an initial public offering and floating Verde as a standalone entity. If this goes ahead then it could result in the creation of a new challenger bank far smaller than the ICB had envisaged should result from the divestment. The ICB in its final report stated that "the entity resulting from the [Lloyds] divestiture will also need to be large enough to exert a competitive constraint on the large incumbents" and expressed concern that this would not happen unless the divestment resulted in the creation of a new entity with at least a 5 per cent share of the PCA market. A standalone Verde would fall below this threshold with the "significant risk" as the ICB noted "that Verde's market share will fall further as it may suffer customer attrition from the divestiture process" with "a real danger that Verde will fall back into the range of small banks that have not exerted a strong competitive constraint in the past".⁷⁹⁵

394. The ICB considered whether there was a case for the relevant authorities to refer any banking markets to the Competition Commission for independent investigation and possible use of its powers to implement remedies under competition law. It held back from recommending "an immediate market investigation reference of the PCA and/or BCA markets", but argued that "such a reference could well be called for depending how events turn out in the next few years, and specifically whether:

- A strong and effective challenger resulted from the LBG divestiture;
- Ease of switching has been transformed by the early establishment of a robust and risk-free redirection service; and
- A strongly pro-competitive FCA has been established and is demonstrating progress to improve transparency and reduce barriers to entry and expansion for rivals to incumbent banks".⁷⁹⁶

The ICB concluded that "if one or more of these conditions is not achieved by 2015, a market investigation reference should be actively considered if the OFT has not already made one following its proposed review in 2012 of the PCA market".⁷⁹⁷ Ms Spottiswoode, a

793 Letter from Ms Ana P Botin to the Chair of the Treasury Committee, 16 October 2012

794 "The Co-operative Group Announcement re: Lloyds Bank Branch Assets", The Co-operative Group press release, 24 April 2013, www.co-operative.coop

795 Independent Commission on Banking, Final Report, September 2011, pp 211–212

796 *Ibid.* pp 231–232

797 *Ibid.* pp 230–232

former ICB Commissioner, elaborated on why the ICB had not recommended an immediate referral:

At the ICB, we looked at this. We thought seriously about doing a full-scale competition review ourselves, and just decided that it was much more appropriate to send it to the Competition Commission at a time to come, and that we should concentrate on other things, because that would have been a huge task. We never seriously looked at structural break-up; we just thought it should happen via a proper, full-scale Competition Commission inquiry at some point.⁷⁹⁸

395. That OFT review of the PCA market has, however, now taken place. The OFT concluded that “significant competition concerns remain in this market” and were extremely critical about how the market was operating. It concluded that:

longstanding competition concerns remain in the PCA market. Concentration remains high, new entry infrequent, and switching low. While there have been improvements around unarranged overdrafts and transparency of charges, charging structures are still complex and comparisons between products remain challenging. Similarly, despite some reduction in error rates, consumers still lack confidence in the switching process. Together, these problems result in a market in which a lack of dynamism from providers combines with consumer inertia to deliver sub-optimal outcomes for consumers and the economy.⁷⁹⁹

396. Like the ICB, however, the OFT held back from a market investigation reference on the grounds that “developments expected over the next few year could have a significant impact on competition in this market”.⁸⁰⁰ The Chancellor, when asked about whether there should be an immediate referral, offered a different set of arguments against doing so:

If there was a referral to the Competition Commission of the banking industry, that is what they would then spend the next two or three years focused on, rather than trying to grow their businesses and expand their lending. You would have to weigh up the benefits of making that referral versus the immediate costs to our recovery. It is not just my view, but the view of the Office of Fair Trading and the view of the John Vickers commission, that that was not therefore a sensible thing to do.⁸⁰¹

Box 11: The Competition Commission and market investigation references

The Competition Commission (CC) is an independent public body which helps to ensure healthy competition between companies in the UK for the ultimate benefit of consumers and the economy. It conducts in-depth investigations into mergers and markets and also has certain functions with regard to the major regulated industries.

The CC does not initiate inquiries independently. All its activities are undertaken following a reference to it by another authority

798 Q 2368

799 Office of Fair Trading, *Review of the personal current account market*, January 2013, p 4

800 *Ibid.*, p 7

801 Q 4343

- Mergers are referred for investigation by the Office of Fair Trading (OFT) or, sometimes, the Secretary of State.
- Market investigations may be referred by the OFT, sector regulators (for markets falling within their sectoral jurisdictions) or the Secretary of State.
- Reviews of merger/market investigation remedies may be referred by the OFT.
- Regulatory references and appeals can be made by the sector regulators in gas, electricity, energy, water and sewerage, railways, airports and postal services.

The Enterprise Act enables the OFT (and the sector regulators) to investigate markets and, if they are concerned that there may be competition problems, to refer those markets to the CC for in-depth investigation.

The CC is required by the Enterprise Act to decide whether any feature or combination of features in a market prevents, restricts or distorts competition, thus constituting an adverse effect on competition (AEC). Market investigations enable the CC to undertake a broad, in-depth assessment of the complexities of a market and focus on the functioning of a market as a whole rather than on a single aspect of it or on the conduct of an individual firm within it.

If the CC finds that features of a market are harming competition, it must seek to remedy the harm either by introducing remedies itself or recommending action by others.

In 2012 the Government announced its plans for reform of UK's competition regime. These include creating a new single Competition and Markets Authority (CMA), which will take on the functions of the CC and the OFT's competition functions and consumer enforcement powers. The Enterprise and Regulatory Reform Bill which gives the effect to these reforms, received Royal Assent on 25 April 2013 and the Government aims to have the CMA fully operational by Spring 2014.

Source: Competition Commission

397. We discussed structural approaches to increase competition in the retail market, as well as a possible market investigation reference with the competition authorities and various competition specialists. Clive Maxwell has on a number of occasions mooted the possibility of such a reference. In a speech in 2012 he stated that “if we do not see real change from banks, then a more radical approach needs to be considered. We cannot just continue working with business on incremental change if this does not deliver sufficient results”.⁸⁰² This so-called Plan B entailed “a market investigation reference to the Competition Commission”, which Mr Maxwell said “should be actively considered if the market has not changed by 2015, and if the OFT had not already made an MIR earlier. The CC can take a detailed and fresh look at a market, and has a range of behavioural and

⁸⁰² Office of Fair Trading, *Competition in UK banking*, Clive Maxwell, 16 February 2012

structural remedies at its disposal, up to and including requiring the break-up of incumbents, as it did in its airports inquiry”.⁸⁰³ Mr Maxwell argued that:

if ‘plan A’ cannot succeed in making the OFT’s vision of the banking market a reality, the obvious question is whether the concentrated market structure of UK banking is the problem. And one way to consider this question would be ‘plan B’—a reference to the Competition Commission.⁸⁰⁴

398. We asked Mr Maxwell in evidence to elaborate on this Plan B. He told us that such an approach involved “driving structural change in a market through divestments and breaking up entities”. However, he cautioned that the Competition Commission had used such an approach “only sparingly” with “the best example [...] the British Airports Authority, where it was felt necessary to break up the market power of an incumbent”.⁸⁰⁵ Mr Maxwell told us that “if the analysis was that that structural issue was the thing that was getting in the way of this market and that if that was solved, it would make a difference, then that is something that the Competition Commission could do if there was a reference to it”.⁸⁰⁶

399. Mr Maxwell outlined the various forms—horizontal or vertical—which structural change could potentially take:

If the Competition Commission were to go away and look at this and if they had a reference, the sorts of options that would be on the table—if they thought that sort of structural change was the right thing to do—would be both vertical and horizontal. The most obvious option for them to consider would be a horizontal chopping up of the banks—in the same way that the state aid divestments are requiring—which is to take out certain bits of the businesses and put them under different sorts of ownership. You might, therefore, create businesses of a certain size that could be credible competitors in the market. We know that there are significant start-up costs and fixed and sunk costs with establishing a bank. We would overcome some of those barriers to entry by creating those sorts of rivals. That would be one way of doing it.

It is interesting to look at the pubs example and to ask whether there are forms of vertical separation that could be looked at in this sort of market, or other sorts of arrangements that could be put in place. Andy Haldane made some suggestions about, for example, requiring the existing banks to make available some of their infrastructure for other rivals to use. That would also potentially overcome some of those barriers to entry. As I have said, those will be questions for the Competition Commission to think about if they were to look at this issue.⁸⁰⁷

We also asked John Fingleton, former head of the OFT, about structural solutions and a possible reference to the Competition Commission. Mr Fingleton outlined two possible

803 *Ibid.*

804 Office of Fair Trading, *Competition in the financial services sector*, Clive Maxwell, 20 June 2012

805 Q 3071

806 *Ibid.*

807 Q 3073

ways forward: “one is if the Government were to nationalise one of the existing banks that it owns a lot of and then sold it off in component parts. The other is to have a reference to the Competition Commission.” Mr Fingleton told us with respect to such referral:

In a sense, that is a more rigorous process—à la airports—and a longer process. The view I took at the OFT on this, which is consistent with the Independent Commission on Banking’s view—I think it is still the OFT’s position—is that we should encourage the banks to make substantial change and the FCA to get up and running with its competition work, but if within a few years we have not seen that delivering positive change, a reference to the Competition Commission would be proportionate and justified.

That may need to happen anyway to deal with a problem, which may not be what you were referring to. In Scotland, for example, two banks rather rule the roost. You may end up getting a very strong entry process through the market working, better entries, and better switching in the south-east of England and other parts of the country, but extend it to quite a tight duopoly north of the border and in other parts of the UK, and you might want a Competition Commission inquiry just to look at that issue, if not at the whole market at that stage. In that sense, the Competition Commission may be asked to look at this in the next decade.⁸⁰⁸

400. Mr Wheatley spoke of how the FCA could use its new competition remit in a variety of ways to increase competition in the retail banking market, but also held out the possibility that the FCA could go further:

If, when we come back to this, we see that those [measures] have not had effect, then we have a broader range of competition powers, which will include references to the Competition and Markets Authority or could include structural changes to the market. Those sorts of things are not taken lightly, and it wouldn’t be something we would come to without quite a lot of study, but structural change to the market could be one of the sets of power that we could use.⁸⁰⁹

401. Both the ICB and the OFT have carefully considered the case for making a market investigation reference to the Competition Commission with respect to the UK banks. Their decision not to propose or make such a reference has had nothing to do with progress in increasing competition within the sector thus far. On the contrary, the OFT, in their recent review of the personal current market, were extremely critical of the lack of progress in increasing competition in this part of the retail market. They concluded that concentration remained high, new entry infrequent and switching low, which “resulted in a market in which lack of dynamism from providers combines with customer inertia to deliver sub-optimal outcomes for consumers and the economy”. The OFT review took place against the backdrop of a rise in concentration in parts of the retail banking market, following the financial crisis.

402. Both the ICB and the OFT have previously held back from referring the sector to the Competition Commission in the hope that a series of reforms currently in the

808 Q 2366

809 Q 4451

pipeline—including the new 7-day switching service, the establishment of a pro-competition FCA and the Lloyds and RBS divestments—would increase competition in the market. Both divestments have failed. Regardless of whether these divestments can be put back on track, it looks increasingly unlikely that a significant new challenger bank will soon emerge from them. Additionally, given the delays in the divestments—which now most likely will take until at least 2014 to be completed—it will not be possible to assess whether they have fundamentally altered competition in the sector until 2017 or 2018 at the earliest. This is too long to wait and should not be used as a justification for, yet again, pushing a market investigation reference into the long grass.

403. The Commission has considered the case for an immediate market investigation reference. There is a strong case for doing so. However, there is also a strong case against an immediate referral. A large number of regulatory reforms to the banking sector are already in train, as well as those recommended by this Commission. An immediate Competition Commission referral would further add to the burden of uncertainty on the sector and would divert the banks from their core objective of recovery and lending to the real economy. We are persuaded that arguments for delay have some merit, but should not be allowed to serve as an argument for indefinite inaction. The scale of the problems in the banking sector, combined with their systemic importance, means they will necessarily continue to be subject to regulatory intervention and upheaval for many years to come. A second argument against an immediate referral is that reform measures already in train will significantly increase competition in the sector. We agree that, while the failure to date of the divestments is a disappointment, a series of reforms in the pipeline have potential to have this effect.

404. The Commission recommends that the Competition and Markets Authority immediately commence a market study of the retail and SME banking sector, with a full public consultation on the extent of competition and its impact on consumers. We make this recommendation to ensure that the market study is completed on a timetable consistent with making a market investigation reference, should it so decide, before the end of 2015. We note that, under section 132 of the Enterprise Act 2002, the Secretary of State for Business, Innovation and Skills has the power to make a reference himself, should he not be satisfied with a decision by the OFT not to make a reference, or the time being taken by the OFT to make a decision on a reference.

Tackling the information mismatch

Introduction

405. In the 1987 film *Wall Street*, the ultimate shark of the financial markets, Gordon Gekko, said “the most valuable commodity I know of is information”. Superior access to information enabled him to “bet on sure things” while the public were “out there throwing darts at a board”. This encapsulates the issue of asymmetries of information in banking set out in Chapter 3.

406. Other industries where there is a substantial disparity of understanding between buyer and seller, such as medicine and law, tend to have strong and established professional standards. Banking does not have this type of culture. The extent to which professional standards can be expected to develop in banking and our proposals for the regulated responsibilities of individual bankers towards customers are considered in Chapter 6. In this section, we consider means of bridging the knowledge gap between banks and their customers at the point of sale, both through ensuring customers are better placed to assess the value of banking products and creating incentives for banks to be more transparent about their products.

407. Information asymmetries have played a role in high-profile conduct failures such as interest rate swap and payment protection insurance mis-selling. However, empowering consumers to make better decisions about the merits of banking services is not simply a means of avoiding future scandals. Informed consumers are better placed to exert market discipline on banks more generally and, in doing so, encourage banks to compete on price and service.

Duty of care

408. One possible measure to address the gap in information and understanding between sellers and buyers of banking products would be to impose some form of duty of care upon banks towards their customers. Mike Dailly of the Financial Services Consumer Panel told the Commission that the Panel had advocated “a regulatory objective for the new Financial Conduct Authority to ensure that there is a duty of care. Obviously, that duty, which would be a statutory duty of care, would be made by way of specific rules through the FCA’s rulebook.”⁸¹⁰ Dominic Lindley of Which? said that “a duty of care is a really important part of any system of profession standards and code of conduct”.⁸¹¹

409. The question of whether a duty of care should be imposed upon financial services firms arose during the pre-legislative scrutiny of the draft Financial Services Bill. Concerns were raised about provisions in the draft Bill that obliged the FCA to have regard to (amongst other things) “the general principle that consumers should take responsibility for their decisions” in pursuit of its consumer protection objective.⁸¹² The Joint Committee scrutinising the Bill recommended that:

the consumer responsibility principle be complemented by an amendment to the draft Bill to place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their customers. The FCA should be empowered to hold firms to account for this and ensure companies address conflicts of interest and the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented.

810 AQ 9

811 JQ 55

812 Joint Committee on the draft Financial Services Bill, First Report of Session 2010–12, *Draft Financial Services Bill*, HC 236/HL 1447, para 112

Clearly, the actions firms should be expected to take will depend on context and circumstances. For example, the way information is presented to retail consumers is likely to be different from that appropriate for a professional investor.⁸¹³

410. In response, the Government amended the Financial Services Bill both to require the FCA in pursuit of its consumer protection objective to have regard to both the fact that “those providing regulated financial services should be expected to provide a level of care appropriate to the consumer involved or transaction being undertaken” and to “consumers’ need for advice and information that is accurate, timely and fit for purpose”.⁸¹⁴ These amendments were given effect in section 6 of the Financial Services Act 2012, which amends the Financial Services and Markets Act 2000.⁸¹⁵

411. The term ‘duty of care’ has a specific legal meaning in the law of torts, and tests to establish whether a duty of care exists and whether it has been breached are a fundamental tenet of common law. In the context of banks and their customers, it is not clear what a duty of care would look like in practice, and where witnesses discussed this it may not have had this in mind. Clive Briault raised the question of what a duty of care would mean:

if you express it at that very high level, you then have exactly the same question asked: what does this actually mean for particular firms in particular circumstances? [...] Either the regulator has to produce rules and guidance to amplify its interpretation of that or, if a duty of care is used by consumers to take legal cases, the courts begin to identify what it is that constitutes an interpretation of that duty of care. But it does not get around the very fundamental question that people will still come and ask: whether this practice, in this market, for this product is acceptable.⁸¹⁶

412. There are limits to the duty owed to customers. Carol Sergeant warned that imposing a duty of care might limit the services banks provide, saying, “yes, people must be treated fairly, but if you make the test too onerous, you are going to find that people will not be providing advice, which is happening at the moment in the financial services industry, and they may not even be providing product”.⁸¹⁷ Dr Hahn of CASS Business School suggested that many issues that might be addressed with a duty of care could be addressed through competition, although as the Commission has established, competition in much of UK banking is weak.⁸¹⁸ The Government, in its approach to the Financial Services Act 2012, has also asserted its view that consumers must take responsibility for their own decisions.⁸¹⁹ There is therefore a balance to be struck.

413. For such a responsibility to be imposed in a meaningful way, it must involve judgements by the regulator and banks about whether customers’ needs are being met and

⁸¹³ *Ibid.*, paras 126 and 128

⁸¹⁴ HM Treasury, *A new approach to financial regulation: securing stability, protecting customers*, Cm 8268, January 2012, para A26

⁸¹⁵ Financial Services Act 2012, Chapter 6

⁸¹⁶ JQ 180

⁸¹⁷ EQ 122

⁸¹⁸ CQ 40

⁸¹⁹ JQ 55

what level of information was needed by each individual customer. As noted by the Joint Committee:

the actions firms should be expected to take will depend on context and circumstances. For example, the way information is presented to retail consumers is likely to be different from that appropriate for a professional investor.⁸²⁰

The difference is not drawn because retail consumers in some sense deserve better treatment than professional investors, but because of the differences in their likely understanding of the transaction they are entering into. This suggests that it is the customer's understanding of the transaction that is important to make a transaction fair.

414. Christine Farnish noted that there was a risk that imposing a duty of care on banks would lead to banks protecting themselves with excessive process, while avoiding taking any real responsibility for meeting customers' needs. She told the Commission:

My concern [...] is that too often we see the banks and other financial institutions responding to regulatory initiatives that are designed to protect consumers simply by building in a lot more process and a lot more disclosure, and by giving thicker, more dense information to the consumer, so that the consumer has everything they possibly need and no one can come back to those banks and say that they have not been treating people fairly or exercised their duty of care.⁸²¹

Dominic Lindley of Which? reinforced the fact that a duty of care must not just involve sticking to the letter of detailed rules, saying that "The main purpose of that kind of message is that what governs acceptable behaviour is not just the letter or the detail of the rules, but what is actually in the best interests of your client".⁸²² This indicates that assessing whether banks are meeting their responsibility does not only involve examining the information given to the customer, but requires a comprehensive assessment of whether the customer has understood the nature and quality of the product they have bought or the service they have paid for.

415. Banks' employees who gave evidence to the Commission varied in their interpretation of a duty of care to customers. A Barclays employee felt that the duty of care was being fulfilled if a customer was satisfied. She told the Commission:

We survey 18,000 customers a month [...] on] the appropriateness of the products and services they were offered. So, every single month we have a litmus test of how we are exercising that duty of care.⁸²³

A Lloyds employee referred to "outcome testing", which was "independent, post-sale contact with customers", measured against set criteria.⁸²⁴ This latter interpretation appears

820 Joint Committee on the draft Financial Services Bill, First Report of Session 2010-12, *Draft Financial Services Bill*, HC 236/HL 1447, para 128

821 AQ 10

822 JQ 55

823 AQ 288

824 AQ 290

to involve a clearer understanding of exercising responsibility towards customers, as a customer may be very satisfied with a product precisely because they do not understand it. We noted in Chapter 2 that purchasers of interest rate hedging products may not have understood until many years after their interaction with their bank that they may incur considerable charges under the terms of the product they had bought.

416. Banks need to demonstrate that they are fulfilling a duty of care to their customers, embedded in their approach to designing products, providing understandable information to consumers and dealing with complaints. A bank has a responsibility to ensure that customers have had a reasonable opportunity to understand a transaction, having regard to their knowledge and personal circumstances. The FCA now has a mandate under its consumer protection objective to enforce this responsibility. Banks should assess whether they are fulfilling it by commissioning periodic independent checks on customers' understanding of the transactions they have entered into and the outcomes achieved. The Commission recommends that the FCA examine periodically whether banks' systems for carrying out their own assessments are adequate.

Empowering consumers through service standards

417. Duties not to take advantage of customers that do not have the capacity to assess the banking services they are offered can be distinguished from the competitive pressures that can be exerted by informed consumers exercising choice between different products and providers. Martin Wheatley told us:

consumers [...] have to be empowered to understand the comparative offerings, so you need a level of transparency about the differences between those offerings, and the differences in terms of cost and quality, such that a consumer can make an informed choice.⁸²⁵

Diane Coyle told us that banks are motivated by “having to get products into the best-buy tables”.⁸²⁶

418. A March 2013 paper by the FSA suggested that in acting in accord with its competition objective, the FCA should be expected to do more than its predecessor to encourage information transparency:

As part of this new competition mandate, there may be an enhanced role for the FCA to review firms' disclosures to ensure they enable consumers to understand and engage with the market. In doing so, we will seek to learn from wider work undertaken on disclosure.⁸²⁷

The FSA paper considered the impact of the publication of complaints data. It expressed some surprise that disclosure of these figures had an impact on the market:

825 Q 206

826 Q 2321

827 FSA, Discussion Paper 13/1, *Transparency*, March 2013, p 9

The FSA has focused on the quality of complaint handling through a number of initiatives in recent years, so establishing a direct causal link between this initiative and the quality of complaint handling is not possible. However, the sentiment from all stakeholders and perhaps unexpectedly, from direct consumer research, suggests that the initiative has helped our objectives and is worth emulating.⁸²⁸

419. Natalie Ceeney told us that she hoped that the experience with complaints data would encourage the FCA to promote the publication of other statistics:

I hope that some of the powers that the FSA and the FCA will have mean that they can act more quickly, particularly on embracing greater transparency. We have found some benefits from publishing complaints data in that the firms that put ethics at the heart of what they do have responded very quickly to some issues. I hope that the FCA will also be able to use transparency to harness public attitude to help change. The tools are there. Whether things happen depends on whether they are used.⁸²⁹

420. Banks told us that they already undertake analysis of how well they are delivering for their consumers, particularly through customer satisfaction surveys.⁸³⁰ Helen Weir, former Principal, Retail Distribution, Lloyds Banking Group, told us that customer satisfaction is not necessarily an effective measure of high banking standards:

We never believed that customer satisfaction alone was an adequate measure of absence of mis-selling; we recognise that customers could be satisfied even when, potentially, they had been mis-sold to.⁸³¹

Carol Sergeant and Clive Briault told us that mystery shopping exercises banks or regulators undertook to assess PPI products were of limited value because they did not tend to follow the process through to sale.⁸³²

421. The FSA's March 2013 Transparency paper suggests that the "publication of claims data for insurance products is one idea that we think could help improve the outcome for consumers and change firm behaviour".⁸³³ Tony Boorman, Deputy Chief Executive and Deputy Chief Ombudsman, Financial Ombudsman Service, explained why this might be useful:

Claims ratios are quite a helpful piece of information for customers. It is part of the evaluation of the product. One of the interesting things that the critical illness part of the insurance industry has done is go through a process of building confidence in customers by explaining the claims ratios that they have, explaining the proportion of cases that are upheld, working with organisations—including ourselves, and also trade associations and customer bodies—to understand why in some cases they are

828 *Ibid.*, p 12

829 JQ 685

830 For example, Ev 802, 1118,1216

831 JQ 637

832 JQq 156, 636–8

833 FSA, Discussion Paper 13/1, *Transparency*, March 2013

turning claims down, and feeding that information back into the front of their process. It is not just about complaints. Understanding complaints and getting feedback from that is important, but it is about getting a thoughtful understanding about the way in which the product interacts with the customer—what goes well, but also what goes badly.⁸³⁴

In attempting to explain why claims ratios had not been published with regards to PPI, Peter Davis, a former deputy Chairman of the Competition Commission, gave an insight into the low regard in which transparency of information was held by the regulators of the time:

Lord McFall: [...] One of your remedies, according to written evidence, was “an obligation to provide information about claims ratios to any person on request”. Why not just require the banks to publish information, as they publish complaints data today?

Peter Davis: As I recall—I will have to revisit the report—the question around the provision of the claims ratio was around the degree to which that particular piece of information would be used and by whom. What we wanted to make sure could happen was that that information could be accessed by, perhaps, websites or people who were going to turn that information into something that was usable by consumers. Potentially, it would have been available to purchase as a product. The question around where it should be published and by whom, and available to whom, is really one of how that particular piece of information would be used in the context of making decisions, how that would impact and then whether that would add to the effectiveness of the remedies in generating competition.⁸³⁵

422. We sought evidence on what the most important areas of banking service provision were for customers, with a view to considering further measures. Ernst & Young told us that they have found there are ten critical areas of consumer interaction with banks. These are: account opening, account closing, account switching, complaints handling, life events such as bereavements and house purchases, lost or stolen cards, first time collections, setting up a payment, change of account details and transparency of fees and charging structures.⁸³⁶

423. The Commission welcomes the FCA’s interest in pursuing transparency of information as a means of exercising its competition objective. Informed consumers are better placed to exert market discipline on banking standards. The Commission recommends that the FCA consult on a requirement to publish a range of statistical measures to enable consumers to judge the quality of service and price transparency provided by different banks. Such measures should be based on customer outcomes rather than only on customer satisfaction levels. Amendment of section 348 of FSMA is likely to be required to facilitate the publication of appropriate information about the quality of service and price transparency.

834 JQ 726

835 JQ 266

836 F Ev 124-126

Tackling the legacy of RBS

Background

424. The Royal Bank of Scotland (RBS) is one of the UK's largest domestic banks and plays a crucial role in the UK economy. A healthy RBS can make a major contribution to the development of a competitive and vibrant retail banking market. Although the Government has injected £45.5 billion of public funds into RBS in 2008 and 2009 and there have been subsequent efforts to clean up the bank's balance sheet,⁸³⁷ it remains a wounded institution. It is still 82 per cent owned by the Government, perceived as vulnerable to political interference and weighed down by legacy problems. These factors inhibit its ability to support economic recovery. They are also obstacles to ending State ownership. This section considers whether the current strategy adequately tackles the challenge of restoring RBS to the private sector in a way which can raise standards by contributing to a competitive and vibrant banking system and serving the country's wider economic interests.

425. The story of RBS's failure and the Government's interventions has already been told in detail in existing reports by the Treasury Committee, NAO and FSA.⁸³⁸ Leaving aside the immediate reasons leading up to the Government interventions, some of the key underlying problems in the business as identified in the FSA's report were poor asset quality arising from aggressive growth, large and uncertain losses in trading activities, and the increased exposure to trading book assets resulting from the acquisition of ABN AMRO on the basis of inadequate due diligence.⁸³⁹ The failure of RBS contained some common elements with the failure of HBOS which we examined in our Fourth Report, including a brash pursuit of rapid expansion, a failure of internal control and a failure of regulation. RBS also served as the archetype for many of the root causes of the crisis of banking standards and culture that we examined in Chapter 3, most notably incentives to grow which led to the bank becoming unmanageable and the development of an aura of untouchability around those who were leading the bank to the brink of an abyss.

426. The most significant Government interventions for RBS were the equity injections totalling £45.5bn—£20bn in October 2008,⁸⁴⁰ and a further £25.5bn of B-shares in February 2009.⁸⁴¹ The average share price at which the Government invested in RBS is equivalent to 502 pence.⁸⁴² In contrast, RBS's share price immediately following the publication of its

837 National Audit Office, *HM Treasury Resource Accounts 2011–12: The Comptroller and Auditor General's Report to the House of Commons*, 13 July 2012

838 Treasury Committee, Seventh Report of the Session 2008–2009, *Banking Crisis: dealing with the failure of the UK banks*, HC 416; National Audit Office, *Maintaining financial stability across the United Kingdom's banking system*, December 2009; FSA, *The failure of the Royal Bank of Scotland*, December 2011

839 FSA, *The failure of the Royal Bank of Scotland*, December 2011

840 "Royal Bank of Scotland Group PLC – Capital Raising", RBS press release, 13 October 2008, www.investors.rbs.com

841 HM Treasury, *Royal Bank of Scotland: details of Asset Protection Scheme and launch of the Asset Protection Agency*, December 2009

842 UK Financial Investments Ltd, *UK Financial Investments limited (UKFI) update on UKFI market investments, March 2010*, p 8. RBS executed a reverse stock split in 2012, therefore a 50p price in 2008 is equivalent to a 502p price today. Current prices are used throughout for consistency.

quarterly results on 3 May 2013 was 295 pence—equivalent to an unrealised paper loss of about £18 billion.

427. The Government also provided other forms of support to RBS during and following the crisis. The Asset Protection Scheme involved the Treasury providing partial guarantees on up to £282bn of RBS's assets.⁸⁴³ RBS withdrew from the scheme in October 2012 without having made a claim and having paid £2.5bn in fees.⁸⁴⁴ Under the Credit Guarantee Scheme, the Government guaranteed certain unsecured bank debts in return for a fee, allowing banks to borrow more easily in wholesale markets. The Special Liquidity Scheme ran from April 2008 to January 2012 and allowed banks to swap assets for more liquid Treasury Bills in return for a fee. RBS borrowed and repaid £75bn under the CGS and SLS, with the last repayment in May 2012.⁸⁴⁵

428. As a result of the support received from the Government, RBS was obliged to accept various restrictions and restructuring measures under EU State aid rules. These included the suspension of discretionary payments on debt instruments, shrinkage of its balance sheet and disposals of specified businesses. The required disposals included Direct Line, RBS's insurance subsidiary, and a significant portion of its UK retail and SME business, including over 300 branches. Completion of the disposals was required by the end of 2013.⁸⁴⁶ RBS agreed to sell the UK branch business, known as "Rainbow", to Santander UK, but announced that Santander had pulled out of the deal in October 2012.⁸⁴⁷

Rebuilding the balance sheet

429. RBS management, led by Stephen Hester, has made good progress in its primary objective of restructuring its balance sheet to improve its financial stability. On all measures of balance sheet strength, the company is ahead of the targets it set itself in 2009. These include overall total asset reduction, wholesale funding reliance, liquidity and capital strength. A particularly large reduction has been achieved in assets in the "non-core" division, which was established in 2009 in order separately to manage assets that RBS intended to dispose of or run off. That division originally held £258bn of assets, many of which were high risk, concentrated, illiquid or linked to proprietary trading.⁸⁴⁸ Remaining non-core assets were £57bn at the end of 2012.⁸⁴⁹ This balance sheet strengthening has reduced the risks the company poses to the taxpayer. Regulators and politicians alike have recognised the progress made in reducing risk. The Chancellor told us:

843 Asset Protection Agency, *Annual Report and Accounts 2009 – 10 of the Asset Protection Agency*, July 2010, HC 259

844 "RBS exits UK Government's Asset Protection Scheme", RBS press release, 17 October 2012, www.investors.rbs.com

845 "2012 Q1 Interim Management Statement", RBS statement, 4 May 2012

846 Commission State Aid Decision (RBS restructuring plan) 422/2009; Commission State Aid Decision (Financial Support measures for the royal Bank of Scotland) 621/2009

847 "Statement on disposal of UK Branch-based Business", RBS press release, 12 October 2012, www.rbs.com

848 RBS, *Annual Report and Accounts 2009*, www.investors.rbs.com

849 RBS, *Annual Report and Accounts 2012*, www.investors.rbs.com

there has been a big reduction in the funded assets on the balance sheet of RBS. It has gone from about £1.5 trillion to about £900 billion. That is a big reduction.⁸⁵⁰

Sir Mervyn King added:

Stephen Hester has struggled manfully to reduce the size of the balance sheet. That was the remit he was given, and he has done a great deal to achieve that.⁸⁵¹

430. RBS has also attempted to reposition its business, increasing the proportion represented by UK retail and business banking and particularly concentrating its balance sheet reductions in the overseas and investment banking activities. As Stephen Hester told us, this was a deliberate policy:

The UK bits of RBS, depending on your measure, are around 70 per cent of the total. Obviously, that is rising, as by far the biggest shrinkage has come from non-UK bits. Retail and commercial banking is getting on for 80 per cent of the total, having been as low as 40 per cent when we took it on.⁸⁵²

431. A breakdown of RBS's assets by division as at the end of 2012 is shown in the table below. Despite the considerable restructuring to date, it can be seen that the UK commercial bank—the retail and corporate divisions—still accounts for only 28 per cent of the core bank's balance sheet and 34 per cent of its risk-weighted assets.

(source: RBS Q1 2013 interim statement)	Total funded assets ⁸⁵³ (£bn)	Proportion of total funded core assets	Risk Weighted Assets (£bn)	% of total core RWAs	Average risk weighting (%)
UK retail	117.1	14.2	44.5	11.5	38
UK corporate	109.9	13.4	87.0	22.5	79
Wealth	21.7	2.6	12.5	3.2	58
International Banking	54.4	6.6	48.9	12.6	90
Ulster Bank	30.6	3.7	36.8	9.5	120
US retail & Commercial	76.3	9.3	58.9	15.2	77
Total retail and commercial	410	49.9	288.6	74.5	70
Markets	288	35.0	88.5	22.9	31
Other (primarily group treasury)	123.8	15.1	10.2	2.6	8
Total Core	821.8	100	387.3	100	47
<i>Non-core</i>	52.9	-	54.6	-	103

432. RBS management has also been successful in substantially reducing the level of impairments and restoring the group to profitability on an underlying basis, although net

850 Q 4339

851 Q 4535

852 Q 4194

853 Note: this excludes assets such as gross derivative positions. RBS's total assets at the end of 2012 were £1,312bn

profits remained negative prior to the first quarter of 2013 due to exceptional costs such as PPI redress and LIBOR fines.

433. However, the balance sheet strengthening remains work in progress. On a pro-forma Basel III basis, the group Core Tier 1 ratio would be 8.2 per cent.⁸⁵⁴ While this compares favourably with the regulatory 7 per cent requirement, when compared with a 10 per cent minimum recommended by the ICB and expected by markets it implies that a further 20 per cent strengthening of the ratio will ultimately be required. RBS was expected to require further capital to meet the recommendations of the Financial Policy Committee, who announced on 27 March 2013 that UK banks have an aggregate capital shortfall of around £25bn following “a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights”.⁸⁵⁵ However, a PRA announcement on 22 May 2013 suggested that RBS now expects to be able to meet any capital shortfall through its existing restructuring plans.⁸⁵⁶

434. RBS is constrained in its ability to increase its capital ratio through issuing new equity because of the Government stake and it has also been limited in its ability to build capital by retaining earnings because of its post-impairment losses since the crisis. Most of the strengthening of RBS’s capital ratio has instead come through shrinking the balance sheet. The Governor of the Bank of England told the Commission this has affected RBS’s ability to supply credit and that in turn, the pace of UK economic growth has been reined in. Sir Mervyn King said:

The legacy problems of the balance sheet of RBS have had macro-economic effects. It has clearly been a drag on the supply of lending to the UK real economy.⁸⁵⁷

The Chancellor agreed that RBS had been a problem for the economy, but argued that things have improved:

the weakness of Royal Bank of Scotland has been one of the major problems for the UK economy emerging from the financial crisis [...] but in the past four or five years, they have gone from great weakness and on the verge of collapse to a stronger position—a healthier capital position.⁸⁵⁸

435. The message from RBS’s own performance is mixed. The RBS 2012 annual results showed UK corporate lending down by £11bn during that year, although this was substantially due to the non-core element, as RBS seeks to rid itself of unwanted exposures. Core UK corporate lending was also down £3.7bn.⁸⁵⁹ In the first quarter of 2013 RBS reported a modest rise in lending to businesses, totalling £13.2bn in loans in the quarter. It said £7.8bn of this was to small and medium-sized enterprises. RBS contracted its stock of

854 “Q1 Interim Management Statement 2013 - summary”, RBS press release, 3 May 2013, www.rbs.com

855 “Financial Policy Committee statement from its policy meeting”, Bank of England, 19 March 2013, www.bankofengland.co.uk

856 “Statement on bank capital”, Prudential Regulation Authority, 22 May 2013, www.bankofengland.co.uk

857 Q 4531

858 Q 4340

859 RBS Group, *Annual Results for the year ended 31 December 2012*, www.investors.rbs.com, pp 40 and 76

lending under the definitions of the Funding for Lending scheme by 1.9 per cent between 30 June 2012 and 31 March 2013.⁸⁶⁰ In contrast, RBS claimed that it had supplied 36 per cent of all new lending to UK SMEs, compared with what it said was its natural market share of 24 per cent based on current accounts.⁸⁶¹ The Chancellor confirmed the picture with regard to support for SMEs:

When we have had targets for bank lending, RBS has actually done better than some in increasing its lending to small businesses.⁸⁶²

436. The extent to which capital and funding issues are constraining lending is disputed. RBS told us that lack of demand was the limiting factor on most of their lending:

The only sector which has been constrained has been real estate finance which reflects a desire to reduce an over concentration in real estate built up over the last 20 years. All other sectors are comfortably below control limits and therefore the level of lending within these sectors has not been affected. The biggest constraint in lending across our book continues to be lack of demand from customers rather than internally imposed targets by RBS.⁸⁶³

RBS also pointed to the fact that lending standards have been appropriately tightened since 2007, meaning that some customers who would once have been given a loan would be refused credit:

Some customers may find it more difficult to secure a loan compared to a few years ago. This reflects a range of factors including a more responsible approach to lending by RBS (with a greater focus on the ability of customer to service debt than in the past) and the more challenging economic conditions leading to weaker and more uncertain cashflows (which are used to service debt). [...] For the 10 per cent of customers where an application for borrowing is declined, the main reasons for the decline centre around insufficient cashflows generated from the business. In such circumstances it would be irresponsible for RBS to provide a loan where the customer cannot afford to service and repay the loan.⁸⁶⁴

437. Sir Mervyn King accepted that there was “both a demand and a supply problem” with credit in the UK. However, he drew a distinction between the two by explaining that some big companies had cash reserves and were not seeking credit due to uncertainties which were “not the fault of the banks.” In contrast, access to credit for SMEs was affected by the capital position of banks and their ability to supply credit, because “banks which have bigger legacy balance sheet problems are contracting their lending”.⁸⁶⁵ Access to bank credit is particularly important for SMEs because they lack the cash reserves of larger firms and cannot access capital markets in the same way. Even where SMEs do have access to credit,

⁸⁶⁰ Bank of England FLS data.

⁸⁶¹ RBS Group, *Annual Results for the year ended 31 December 2012*, www.investors.rbs.com, p 3

⁸⁶² Q 4340

⁸⁶³ A Ev 62

⁸⁶⁴ A Ev 63

⁸⁶⁵ Q 4542

we heard evidence that conditions have tightened and become more onerous, for example in the quality of collateral required or the spreads charged.⁸⁶⁶

438. Chris Giles has recently contended that, because “small companies account for less than a 10th of business investment [...] only a very small part of the growth shortfall can be blamed on credit restrictions to small companies”.⁸⁶⁷ However, even if constrained SME access to credit did only have a limited direct effect on the economy, the legacy of weak bank lending to SMEs over the last 5 years is likely to have had a much broader indirect effect on small business confidence and therefore contributed to the lack of credit demand. Larger firms’ willingness to invest may also be influenced by a lack of confidence to which the dysfunctionality of banking over the past five years has contributed. In addition, while uncertainty remains over banks’ capital strength, corporate customers’ overall confidence may be undermined and they might be more cautious in their expansion plans, not least triggered by concerns that banks could unexpectedly withdraw funding.

439. The Breedon Report on business financing, published in 2012, made the case that, even if current levels of lending could be explained by a lack of demand, there was a risk that, during the next phase of recovery banks might not be in a strong enough position to supply the credit that would be needed to meet the expanding needs of businesses:

between now and the end of 2016, there is a risk that UK businesses are likely to need more credit than will be available. [...] this finance gap could be in the range £84bn to £191bn – the amount potentially required to meet comfortably the working capital and growth needs of the UK non-financial business sector.

[...] analysis of the impact of domestic and international regulation suggests that the ability and willingness of banks to lend to businesses will be constrained in future. Capital adequacy rules have tightened considerably including higher capital ratios and new specific rules on risk weightings on SME loans and overdrafts. The impact of these rules is likely to fall disproportionately on smaller businesses which tend to be riskier and have higher risk weightings attached.⁸⁶⁸

440. Sir Mervyn King argued that it was only when all the major banks had rebuilt their balance sheets that the sector as a whole would be in a position to supply credit normally. He commented:

The legacy problems on the balance sheets of some of our banks have been largely responsible for their wish to contract lending to the UK real economy. The banks with the largest amounts of capital have actually increased their lending; Barclays, HSBC and Nationwide have lent more to the UK real economy. RBS and Lloyds, unsurprisingly given their balance sheet legacy problems, have been contracting lending. All of that is completely natural and understandable. Only dealing with

866 | Ev 35

867 “Bank lending boost won’t turn UK round”, *The Financial Times*, 10 April 2013, www.ft.com

868 Department for Business Innovation and Skills, *Boosting finance options for business*, March 2012

those legacy balance sheet problems as soon as possible will get you into a different position.⁸⁶⁹

441. The Chancellor agreed that weaknesses in UK banks have had a wider economic impact, saying “our banking industry is a larger proportion of our GDP, so weakness in the banking industry spills over even more than in the US”.⁸⁷⁰

442. Given that RBS is one of the UK’s biggest SME lenders, responsible for 36 per cent of new lending,⁸⁷¹ its continued position as one of the more weakly capitalised banks creates concern about its ability to provide adequate credit as the economy picks up. It could be argued that other large banks in the UK are in a stronger position than RBS and therefore have the capacity to pick up any shortfall in its lending; both Barclays and HSBC have grown their UK corporate loan books in 2012.⁸⁷² However, regardless of overall capacity, it may not be easy for many existing customers of RBS to switch to alternative providers, due to some of the barriers to competition discussed earlier in this chapter. For example, in Scotland in particular, RBS and Lloyds Banking Group together have 70 per cent of the market share for SME business,⁸⁷³ so any dysfunction in RBS is likely to have a pronounced impact.

The effects of public ownership

443. The Government’s continued ownership of major banks is widely held to have had a negative effect on confidence in banking, and on confidence in the UK economy. When the Chancellor announced his intention to sell Northern Rock in June 2011, he set out the case for privatisation in these terms, which apply equally to RBS:

its chaotic collapse did great damage to Britain’s international reputation. Its return now to the private sector would help to rebuild that reputation. It would be a sign of confidence and could increase competition in high street banking. We could start to get at least some of our money back.⁸⁷⁴

444. Government ownership of banks creates a risk of interference or the perception of interference which can undermine their autonomy and commercial decision-taking, limit willingness to lend and depress the long-term value of the firm. RBS has already been under public ownership for over four years. Sir Mervyn King referred to the experience with State ownership of banks in other countries:

The lessons both of the failure of Japan to do this and for their banking system to be hobbled for a long time because they were not decisive enough in dealing with it, in contrast to the Scandinavian experience in the early 1990s when they took banks into

869 Q 4539

870 Q 4341

871 RBS Group, *Annual Results for the year ended 31 December 2012*, www.investors.rbs.com, p 3

872 “Barclays PLC Results Announcement”, Barclays, 31 December 2012, p 28; HSBC Bank Annual Results press release p 15.

873 IQ 4 [Colin Borland]

874 Speech by the Chancellor of the Exchequer at the Lord Mayor’s dinner for bankers and merchants of the City of London, Mansion House, 15 June 2011

public ownership for a short time to restructure and recapitalise and put them back into the private sector, show very clearly that it is not a good idea to have banks in the public sector for very long.⁸⁷⁵

445. Sir Mervyn King thought that “the whole idea of having a bank that is 82 per cent owned by the taxpayer, run at arm’s length from the Government, is nonsense. It cannot make any sense”.⁸⁷⁶ Vince Cable has commented that he had argued for full nationalisation at the time of the RBS collapse for this reason:

But that was not what happened and we are now living with the consequences. In many respects, this Government inherited from its predecessor the worst of all worlds—responsibility without control.⁸⁷⁷

The Chancellor admitted that, while the Government had “kept the UKFI model—that is, this is managed at arm’s length”, it had nevertheless exerted influence over RBS: “as the major shareholder, through UKFI acting independently on our behalf, we have insisted that, actually, they do change their business model”.⁸⁷⁸

446. Robin Budenberg, the Chairman of UKFI has defended to Parliament the value his organisation adds:

I certainly think that market participants see the role that UKFI plays as very helpful. One of our roles is to make sure that disagreements do not arise between Government and the banks, and that applies to all banks, but it is particularly the case where the banks have Government shareholdings. One of the things we do is explain both to the banks and to the Government what the position of the other is, to make sure those disagreements are less likely to arise. That is in the commercial best interests of the banks. I think market participants see that and feel we comfortable that we do play that role, recognising that if at any stage the banks are asked to do something that is fundamentally not in their commercial best interests, then it is our role, supported by our board, to make sure that the banks know that we are going to stand up for them and prevent that from happening.⁸⁷⁹

447. However, in evidence to Parliament Mr Budenberg set out in some detail the extent to which the Chancellor has directly engaged in discussions about RBS remuneration. For example in relation to Stephen Hester’s bonus, he said that the Government was “very clear” in the guidance they gave UKFI that “they wanted to make sure that this decision was made in the context of the climate on remuneration, and they wanted to make sure that it was substantially lower than the figure that was announced for Stephen Hester last year [2010]”.⁸⁸⁰

875 Q 4532

876 Q 4534

877 Department for Business Innovation and Skills, Speech on Banking by the Secretary of State for Business, Innovation and Skills, Rt Hon Vince Cable MP, 6 February 2013

878 Q 4333

879 Oral evidence taken before the Treasury Committee on 23 October 2012, HC (2012–13) 672, Q 8

880 Oral evidence taken before the Treasury Committee on 14 March 2012, HC (2010–12) 1896, Q 14

448. Furthermore, Sir Phillip Hampton, Chairman of RBS, has previously warned about the dangers as well as the consequences of political interference in RBS:

It is the Board's view that running the business on commercial grounds is the best way to make the bank safer and more valuable for everyone who depends upon it. I do not believe there is a workable alternative if our aim is to provide the opportunity for the UK government to sell its shares in the public markets in a reasonable timescale.⁸⁸¹

449. Robin Budenberg, Chairman of UKFI, told the Treasury Committee that political interference in the running of RBS:

certainly has the potential to affect the share price. [...] there are inevitably situations—we discussed one of them last time around Stephen Hester's bonus—where public concern about banks that have Government shareholdings in them makes it difficult in terms of the commercial operation of the banks.⁸⁸²

Concerns about the consequences of political interference in the running of the partly State-owned banks, particularly RBS, have also been expressed by market participants. For example, bank analyst Manus Costello told the Treasury Committee in May 2012 that “there clearly have been some signs that commercial strategy is being influenced by public pressure, the CEO's compensation being an obvious one during the course of this year”.⁸⁸³

450. The Royal Bank of Scotland Group is one of the UK's largest domestic banks and plays a crucial role in the UK economy, particularly in relation to small and medium enterprises. The current state of RBS and its continued ownership by the Government create serious problems for the UK economy, despite the commendable work of Stephen Hester and his team in cleaning up its balance sheet since 2008. RBS's capital position remains weak, impairing its ability to provide the levels of lending or competition needed for the restoration of vitality to the banking sector and for the UK's full economic recovery. RBS continues to be weighed down by uncertainty over legacy bad assets and by having the Government as its main shareholder. Such problems for one of the UK's largest banks weaken confidence and trust in banks and bank lending. They also undermine wider economic confidence and investment activity even for firms not facing immediate credit constraints.

451. UKFI was established by the previous Government to manage the Government's shareholdings in the State-owned and partly State-owned banks, but also crucially to ensure that Government was not involved in the day-to-day running of these institutions, thereby ensuring that they would be run on commercial lines, thus facilitating an early return to the private sector. These were sensible aims, but they have not been fulfilled. Instead, the Government has interfered in the running of the two partly State-owned banks, particularly RBS. On occasions it has done so directly, on others it appears to have acted indirectly, using UKFI as its proxy. The current

881 RBS, *Annual Results for the year ended 31 December 2011*, p iv

882 Oral evidence taken before the Treasury Committee on 23 October 2012, HC (2012–13) 672, Q 5

883 Oral evidence taken before the Treasury Committee on 15 May 2012, HC(2012–13) 73, Qq 28-29

arrangements are clearly not acceptable. Whatever the degree of interference, UKFI will increasingly be perceived as a fig leaf to disguise the reality of direct Government control. The current arrangements therefore cannot continue. It could be argued that bolstering UKFI's independence from the Government is the way forward. It may be possible to bolster UKFI's independence, but this would be extremely unlikely to end political interference in the State-owned banks. In the present economic and political climate, governments will continue to be tempted to influence or intervene in the banks. The Commission has concluded that UKFI should be wound-up and its resources absorbed back into the Treasury.

RBS's current strategy

452. RBS's strategy for restoring its balance sheet and exiting public ownership has changed little over the last four years, although the Chancellor argued that the Government has insisted that they "change their business model and they do shrink their investment bank much more than they had previously wanted to do".⁸⁸⁴ The strategy involves managing the run-off of the remaining non-core assets and gradually shrinking the investment banking operations, with the aim of making the bank more attractive to investors, restoring payment of dividends, lifting the share price and getting to a point where the Government's shareholding could start to be sold off. Stephen Hester argued that the restructuring process he had overseen was nearing completion, and that RBS should soon be ready for a return to the private sector:

I hope the process that we have undertaken of very radical reform is close to practical completion. In other words, as we move into 2014 and soon thereafter, I hope that this company's restructuring period is, if not fully behind it, largely behind it, and that we are able to start thinking about dividends again and indeed that the privatisation can happen thereafter.⁸⁸⁵

Shortly after giving evidence to the Commission, RBS published results containing more detail on its restructuring plans, including a partial flotation of their US banking business Citizens in around two years, and a further reduction in the scale and scope of RBS's markets activity.⁸⁸⁶ The message that the bank would be ready for return to the private sector in 2014 was reinforced by Sir Philip Hampton at the time of the publication of the 2013 first quarter results.⁸⁸⁷

453. However, giving evidence after the RBS announcement on its 2012 results, Sir Mervyn King raised doubts about whether the proposed steps were bold enough:

It is four and a half years on and there is no immediate sign of it going back to the private sector. That means that we have not been sufficiently decisive in either recapitalising the bank or restructuring it. I sense, from comments of the Prime Minister and the Chancellor, that they feel too that they are rather frustrated in their

884 Q 4333

885 Q 4192

886 RBS Group, *Annual Results for the year ended 31 December 2012*, www.investors.rbs.com

887 "Q1 interim management statement 2013", RBS Group, 3 May 2013, www.rbs.com/news

attempts to get this bank back into playing a role as a healthy UK bank, lending to retail and commercial clients. I think that will need a more decisive approach to the restructuring and recapitalisation of the bank.⁸⁸⁸

Obstacles to early disposal

454. There are several reasons to share Sir Mervyn King's doubt about whether RBS will be in a position within the next year or two that will mark the end of restructuring and allow the Government to start selling its stake. Potential obstacles considered further below include:

- The uncertain value that is still attached to many assets;
- Concerns over the shape, coherence and underlying profitability of different parts of the business;
- The limited prospect of a dividend;
- The Government's approach to the price of sale.

455. The uncertain valuation attached to many of RBS's legacy assets makes it an unattractive and risky investment. These include not just those already placed in the non-core division but potentially other risky assets as well, such as loans made by Ulster Bank and some other corporate and commercial real estate loans. For example, even though these assets are already heavily marked down on RBS's balance sheet, one recent analyst report suggested that RBS's commercial real estate and Irish lending might be underprovided to the tune of £8.6bn.⁸⁸⁹ However, such assets are difficult to value with certainty because their performance might be both heavily dependent on wider economic conditions and on the specific details of loans, which are not publicly available. RBS's existing strategy reduces the quantity of these assets over time, but they are likely to remain an impediment to selling down the Government stake except at a significant discount.

456. In addition to the difficulty of valuing such assets, Sir Mervyn King expressed a concern about the coherence of the bank in its current shape, saying "RBS has a portfolio of different activities which do not sit well enough together to make the market willing to bid for it".⁸⁹⁰ The retention of a sizeable portion of the investment bank is particularly questionable, given the increased pressures on such operations from the current environment and new regulations, and the fact that RBS is not one of the market leaders in this space. RBS's Q1 2013 results showed a sharp fall in the profitability of the markets division—down 66 per cent on the same quarter a year earlier. Although RBS is approaching the shape which management intended when it set out with restructuring four years ago, it is no longer clear that such a shape—with a continued significant presence in wholesale and overseas markets—delivers a sustainable business model which would be attractive to buyers. The plan to retain this wider range of activities also means

888 Q 4531

889 Macquarie Equities Research, *RBS Group struggling to deliver returns*, 6 March 2013

890 Q 4532

that RBS will not be focused on what should be its core strength—the UK commercial and retail activity which is of greatest importance to the UK economy.

457. Another deterrent to potential buyers is RBS's limited ability to produce a dividend. The prospect of RBS resuming dividend payments depends on it both returning to profitability and reaching a capital position where it no longer needs to retain earnings. This may be difficult to achieve within the 18-month timescale suggested by RBS management. Proposals to sell the US bank Citizens and shrink the investment bank further may allow RBS to meet regulatory capital requirements, but look likely to still leave it relatively weakly capitalised. One recent analyst report on RBS stated that, "due to political, regulatory, and market pressures, RBS is seeing a massive reduction in its pre-provisions earnings capacity".⁸⁹¹ Another added "Management would like to pay a dividend in 2014, but this is optimistic, in our view, unless asset sales are made or we see a recovery in markets improving the group's earnings and capital".⁸⁹²

458. RBS is also constrained in its ability to pay dividends to private shareholders by the "dividend access share" which the Government holds. This requires RBS to pay the Government 250 per cent of any dividend they pay to ordinary shareholders, and only expires when the share price exceeds 650 pence for 20 days in any 30 day period.⁸⁹³ Given the current share price, the access share has considerable value—estimated by some analysts at approximately £1.5-£2bn.⁸⁹⁴ The Government would need to conclude a commercial agreement for RBS to buy back the access share, although the agreed price might differ from the share's theoretical value.

459. These factors help to explain RBS's current depressed share price, as does uncertainty about whether the Government might intervene in the firm's strategy. A recent analyst note on RBS shares reflected this, stating "High level of political uncertainty justifies discount".⁸⁹⁵ RBS's price to book ratio as of 31 March 2013 was only 60 per cent, compared with 75 per cent for Barclays, 90 per cent for Lloyds Banking Group and 152 per cent for HSBC Group.⁸⁹⁶ This demonstrates markets' lack of confidence in the supposed value of the firm. The share price is also likely to be depressed by the "overhang" of Government ownership—the knowledge that the Government wants to unload a large number of shares into the market at some point in the future.

460. In considering reprivatisation of RBS, the Government should try to ensure best value for the taxpayer and the wider interests of the UK economy.

461. The current plan for dealing with RBS risks being insufficient. Although RBS management claim they will be ready to at least begin flotation of the bank in 12 to 18

891 Research commissioned by Autonomous, *RBS: shrinking pains*, 4 March 2013

892 Research commissioned by Nomura Equity Research, 4 March 2013

893 Letter from RBS Chairman to shareholders, 27 November 2009

894 Research commissioned by Autonomous, *RBS shrinking pains*, 4 March 2013; Nomura Equity Research note on RBS, 4 March 2013

895 Research commissioned by Exane BNP Paribas on RBS, 18 March 2013

896 RBS, *Interim Management Statement Q1 2013*, 3 May 2013, www.investors.rbs.com, Barclays, *Interim Management Statement*, 31 March 2013, www.barclays.com, HSBC, *Interim Management Statement Q1 2013*, www.hsbc.com; Lloyds Banking Group, *Q1 2013 Interim Management Statement*, 30 April 2013, www.lloydsbankinggroup.com

months, others have challenged the credibility of this claim. There remain on the balance sheet assets with uncertain value and limited relevance to the UK economy.

Other strategies

462. A number of different approaches for dealing with RBS have been mooted. These include:

- beginning to sell the Government stakes —either in part or whole—immediately;
- distributing shares in RBS to the public through a so-called helicopter drop;
- a more radical internal restructuring and shrinking of RBS;
- splitting RBS into a good bank and a bad bank as separate legal entities, before returning the good bank to the private sector; and
- splitting up RBS's commercial operations, whether through the creation of a number of regional banks or through the establishment of multiple challenger banks.

463. The first of these options, involving a rapid sale without further restructuring, would achieve the objective of returning RBS to the private sector but would likely achieve poor value for the Government, for the reasons described earlier. The benefits to the Government's balance sheet of getting the cash back quickly would be limited, given current low borrowing costs, in comparison with the lost value.

464. The second option, of giving away shares to the general public, has been proposed by various people including the Secretary of State for Business Vince Cable, who in a recent speech argued that this, as well as other options, should all be kept in play:

The early hope of re-privatisation now looks a very long way off, unless at an unacceptable loss. For the existing semi-state owned companies, there is a range of options from reprivatisation at a later stage to continued public ownership or mutualisation through public share distribution [...] We should keep all these options in play⁸⁹⁷

This public distribution could be done free of charge, which would involve a permanent loss to the Government balance sheet. Alternatively, one model put forward by Portman Capital and CentreForum involves giving away shares but only allowing individuals to retain profits above a certain floor price, the value of which would return to the Treasury when shares were sold.⁸⁹⁸ The downsides of such approaches include their operational complexity, issues around fairness and the resulting highly diluted ownership of the bank.

465. A sale or distribution of the Government's stake in RBS would not by itself address the questions identified above about the bank's structure, sustainability and ability to support

⁸⁹⁷ Speech on Banking by the Secretary of State for Business, Innovation and Skills, Rt Hon Vince Cable MP, 6 February 2013

⁸⁹⁸ CentreForum, *Getting your share of the banks: giving the banks back to the People*, March 2011, www.centreforum.org

economic recovery. These are therefore at best partial solutions. Any complete solution must include a clear vision of RBS's ultimate shape. This is likely to require a more radical restructuring of RBS's operations.

A 'good bank / bad bank' split

466. The objective of splitting RBS and putting its bad assets in a separate legal entity would be to deliver a good bank that was free of RBS's legacy problems, focused on its UK retail and commercial activities and no longer distracted by overseas operations or a large investment bank. It is argued that such a bank would be able to make a strong contribution to UK economic recovery and would be far more attractive to investors, allowing it to be quickly returned to the private sector at a fair price. This approach has reportedly been considered several times before but never pursued, in part because of the considerable obstacles and in part because of the hope that RBS's situation would resolve itself over time without such radical measures.⁸⁹⁹ Nearly five years on from the first intervention, RBS's situation, while improved, is not resolved. Some have said that it is too late to try a bad bank now as RBS's own restructuring is nearly complete, claiming that the prospects of a sale are just around the corner.⁹⁰⁰ However, the same people often concede that a bad bank would have been the right solution several years ago.⁹⁰¹ By waiting and not acting now, it is argued that the UK would risk making the same mistake again. There are significant potential obstacles to such an approach including the fiscal impact, the operational complexity and the time it might take to complete. The key issues in relation to each are discussed below, but more detailed analysis is urgently required to assess to what extent these are real obstacles and not just excuses.

467. Sir Mervyn King strongly advocated such an approach:

I do not think it is beyond the wit of man to devise a plan which would enable you to restructure RBS, to divide it into a bank that could be a new RBS that would be a healthy, well capitalised bank, capable of lending to the UK real economy and attracting funding to finance that lending, and therefore could be sold back to the private sector relatively soon. It does mean, however, being decisive in dealing with those activities that would go into the other part of the bank, which would be separated from the new RBS, which would then have to be run down over a period of time⁹⁰²

In its Report on the 2013 Budget published in April 2013, the Treasury Committee also considered evidence on the partly State-owned banks, and recommended that by the time of the spending review in June 2013 "the Government publish its analysis of the pros and cons of creating a 'bad bank' for the banks in which the Government has a stake".⁹⁰³

⁸⁹⁹ "Treasury to burn midnight oil on 'bad bank' scheme", *The Telegraph*, 16 January 2009, www.telegraph.co.uk; "Underemployed APA unveils plans for RBS 'bad' bank", *The Financial Times*, 8 July 2011, www.ft.com

⁹⁰⁰ Q 4192

⁹⁰¹ Q 4534

⁹⁰² Q 4532

⁹⁰³ Treasury Committee, Ninth Report of Session 2012–13, *Budget 2013*, HC 1063, para 28

The shape of a split

468. Good bank / bad bank splits have been done many times before, in the UK, most notably by the last Government who split Northern Rock into a good bank and a bank, as well as in other countries. After its nationalisation in January 2010 Northern Rock was split into a good bank which was subsequently sold to Virgin Money, and Northern Rock Asset Management (NRAM) which remained in public hands and is being wound down. The Republic of Ireland conducted a similar exercise with its banks, including those which are not fully nationalised, involving the forced sale of €74bn of troubled assets to the National Asset Management Agency at an average discount of 57 per cent to face value.⁹⁰⁴ In the US, the Federal Reserve Bank of New York established and funded special vehicles to buy \$73bn of bad assets from AIG and Bear Stearns in 2008, in what were known as the “Maiden Lane” transactions.⁹⁰⁵ UBS placed approximately \$60bn of assets in a bad bank funded by the Swiss Central Bank in 2008, generating a significant capital hole which the Swiss Government then filled. Looking further back, the Swedish authorities used a bad bank in resolving its banking crisis in the early 1990s.⁹⁰⁶ Citibank conducted an internal good bank/bad bank split in 2009, creating Citicorp as the good bank and Citi Holdings to take approximately \$850 billion of non-core assets—over 40 per cent of the group’s balance sheet.⁹⁰⁷

469. An ideal good bank following a split would contain only assets which support RBS’s strategy as a UK-focused retail and commercial bank, and which reflect new lending or refinancing in support of the UK economy rather than legacy loans in run-off. One analyst report suggested that this idealised good bank might only account for about £250bn of assets focused around UK retail, UK corporate and wealth divisions, leaving a bad bank of with assets of over £1 trillion including the whole investment bank balance sheet.⁹⁰⁸ However, this is at one far and unlikely end of a spectrum of possible points of split. At the other a bad bank could simply take the existing £57bn of non-core assets. While such a minimalist approach would be unlikely to deliver the necessary level of change, there are several reasons why it might be appropriate to have a bad bank closer to this end of the spectrum.

470. First, there are other assets on RBS’s current balance sheet which could usefully form part of even a slimmed down and UK-focused good bank. Stephen Hester argued that some markets activity would be an important complement to RBS’s ability to service corporate clients:

in order to fulfil our corporate mission, we had to have some markets activity to be credible in the things which corporates used, but they did not have to be anywhere close to the scale on which they were being undertaken. That is why we shrunk the

904 National Asset Management Agency, www.nama.ie

905 Federal Reserve Bank of New York, www.newyorkfed.org

906 Clas Bergström, Peter Englund and Per Thorell (Translation- Timothy Chamberlain), “Securum and the Way Out of the Swedish Banking Crisis”, Center for Business and Policy Studies, May 2013

907 “Citi to Reorganize into Two Operating Units to maximize value of Core Franchise”, Citigroup Press Release, 16 January 2009, www.citigroup.com

908 Research commissioned by Credit Suisse, *Good bank/bad bank: Looking at options*, 12 March 2013

investment banking activities more dramatically than any other bank in the world and exited huge swathes of them, but I do think that we would not have the role we have in serving corporates in this country if the answer was zero in the group.⁹⁰⁹

One Nomura analyst note pointed out that “RBS also has a leading Corporate Banking franchise in the UK. Thus material parts of the Markets as well as International Banking divisions would also be required within [the good bank]”.⁹¹⁰ Some parts of Ulster Bank might also be left in the good bank because this is a business which actively supports the economies of Northern Ireland and the Republic, even though many of its legacy assets are likely to go to the bad bank.

471. Second, there are assets for which the intention should be to sell them off entirely, either during the period when restructuring would be taking place or shortly thereafter, such as Citizens and Direct Line. Finally, there may be some categories of assets where the benefits of moving them to the bad bank do not justify the cost or complexity of doing so. This might in particular include some of the markets division, since moving investment bankers and wholesale trading positions into a government-owned bad bank could be particularly challenging.

472. Alongside the process of splitting RBS into a good bank and a bad bank, it would also be important to accelerate the disposal of any activities which would not form part of a re-focused RBS but which the Government decided not to take into the bad bank. This should both re-focus the good bank and help RBS reduce its risk-weighted assets, thereby helping it meet the FPC’s new capital requirements. In particular, it could be desirable for RBS to accelerate the full disposal of Citizens rather than simply prepare it for a partial IPO in two years time. RBS would also need to pursue a deeper and more rapid shrinkage of any parts of the investment bank left in the good bank beyond those required to service current and future corporate customers.

473. As we argued in our First Report, despite the important moves towards ring-fencing of UK banks, concerns remain about the impact of large-scale investment banking activity on standards of retail banks. There would therefore be wider benefits to standards from taking this opportunity to focus RBS more as a retail and commercial bank and away from its trading and investment banking activities. Such steps would also ensure that the new RBS was well-prepared to meet the incoming ring-fencing requirements well ahead of the 2019 deadline—something that RBS would have to do even if the good-bank / bad-bank split were not carried out.

474. Completing a good-bank / bad-bank split and winding down other non-core activities could reduce uncertainty. It could make the core of RBS a strong, profitable UK-focused business which would be much easier to value and therefore more attractive to investors. The Government would therefore be able to start selling its stake as soon as the split was completed if the necessary preparation were done during the interim. There are recent examples in the US in particular of how disposals of stakes in financial institutions can be

909 Q 4176

910 Research commissioned by Nomura Equity Research, 7 March 2013

successfully completed once restructuring is complete. By January 2012 the US Treasury had already received \$211bn in repayments, dividends and interest on its original \$205bn investment under the Capital Purchase Program.⁹¹¹

475. There are various options for how the stake could be sold. One approach would be for the Government to sell tranches of its stake to institutional investors or onto the stock market over time. Stephen Hester has said:

I certainly think that the sale of the government shares will take quite a few years and have to happen in several different bites because the amount is simply too much to do in one go.⁹¹²

476. Another could be to float some or all of the restructured good bank via an initial public offering (IPO), although this could only be achieved in circumstances where the good bank was being floated as a new entity, which could take longer to achieve. This could also have the advantage of bringing in new capital to strengthen the balance sheet and fill any capital holes resulting from write-downs of assets transferred to the bad bank. The existing minority shareholders could be given pre-emption rights in an IPO to help secure their cooperation with the restructuring and avoid nationalisation.

Challenges in creating a bad bank

477. There are multiple ways of carving a good bank/bad bank split out of RBS, depending on what was transferred, how it was transferred and how it was paid for. Different approaches could give rise to a number of important specific and common challenges.

Valuing assets

478. One way of creating a bad bank would be for the Government simply to purchase assets from RBS, either in exchange for cash or government bonds or potentially along with a book of matching liabilities. This would be a commercial transaction, so would need to be negotiated with RBS management and minority shareholders. The key issue for negotiation would be the valuation of the assets. Transferring them at close to their current book value would involve the Government taking a risk if the assets transpired to be worth less, whereas the minority shareholders might be expected oppose transferring assets at a significant discount since this would crystallise losses. Transferring at a discount could also trigger a need for additional capital to be injected into RBS to fill the resulting hole.

479. Determining an appropriate value might require a complex and detailed valuation exercise, which could result in a significant delay given the volume of assets transferred.

911 GAO, *Capital Purchase Program: Revenues Have Exceeded investments, but Concerns About Outstanding Investments Remain*, March 2012

912 "The Andrew Marr show: transcript of Stephen Hester interview", *BBC News*, 26 February 2013, www.news.bbc.co.uk

Funding the bad bank

480. If the Government simply purchased assets for the bad bank, it would have to issue a significant volume of gilts which if done quickly could have undesirable consequences for gilt markets and the price of Government borrowing. One alternative could be to transfer some wholesale creditors of RBS to the bad bank as well, to reduce or eliminate the funding requirement. It might be possible to minimise the actual capital requirements for the bad bank, since it would not be a deposit taker. It is however likely that the Government would need to guarantee any debts transferred to the bad bank, which would create a contingent liability. Another alternative might be for the Bank of England to fund the bad bank, although again this would likely require a Government indemnity. All of these alternative funding models therefore result in some form of real or contingent liability for the Government.

Shareholder consent

481. The consent of minority shareholders would be needed to permit a deal, and they could block it and hold out for a price which the Government was unwilling to pay. An alternative approach could therefore involve fully nationalising RBS prior to a split, by acquiring the remaining 18 per cent of shares currently in private hands. It is likely that the Government would need to pay a premium to the current market price of the shares to acquire control. The market value of the shares has recently been trading in the range of £3-4 billion. Once the Government owned 100 per cent of RBS, it would have the advantage of being able to transfer assets without having to negotiate with shareholders.

482. One way to avoid a minority shareholder dispute and the need for nationalisation could be to purchase the assets at a discount, but offer minority shareholders some form of compensation, perhaps via some form of warrant, if the assets later turned out to be worth more than their transfer price. Another alternative to nationalisation could involve forcing the compulsory sale of assets from RBS to the bad bank, which would follow the example set by the Irish authorities in compelling the sale of assets from the Irish banks to NAMA.

483. The Government does not appear to currently possess adequate legal powers to compel nationalisation or the compulsory sale of assets if shareholder consent cannot be negotiated. Legislation might be passed to provide such powers, but this could cause significant collateral damage to the reputation and investability of the UK banking sector, and might have knock-on effects on Lloyds Banking Group, the other bank in which the Government also holds a large stake. In order to reduce the legal and reputational risks, the Government might need to commit to paying some form of independently-assessed compensation.

Operational complexity

484. RBS is, even following several years of shrinkage, still one of the world's largest and most complex banks. It is the product of multiple mergers and acquisitions and has tens if not hundreds of legal entities spread across the world. If RBS liabilities were placed in the bad bank to reduce the need for the Government to inject cash or bonds, this would affect

the rights of third parties and could trigger counterparty consent or change of control provisions. This would likely be a particular barrier to transferring derivative positions, which could be significant obstacle to placing the markets division to the bad bank. Resolving this could require complex negotiations and legal processes, or might even require legislation. Again, legislating to over-ride creditor rights would not only create legal risk but could cause reputational damage to the UK as a place to do business.

485. There would also be operational issues to tackle, such as how legal title to assets would be transferred, what IT would be needed to run both the good and bad bank, and the division of staff between the two entities. Analysis of these factors would need to form part of the decision about the boundaries of the bad bank, in order to ensure that it had a meaningful impact but in the shortest possible time. It should be noted that RBS is already configured internally on good bank/bad bank lines.

Length of time to complete a split

486. Another potential obstacle to radical reform is the time it might take to complete. Sir Mervyn King asserted that “it should not take more than a year”.⁹¹³ However, Sir Nicholas Macpherson, Permanent Secretary to the Treasury, warned the Treasury Committee

When we set up the Asset Protection Agency, we did look at the option of a good bank-bad bank, and it may yet be the right way forward, but it does take time, and you only have to look at the Irish experience with issues around valuation of the assets affecting the transfer to see that it is far from simple. So it may be the right thing to do it, but you should be under no illusion that it will take quite a lot of time.⁹¹⁴

He also warned that establishing a bad bank for RBS would be considerably more complex than for Northern Rock:

This is not like splitting up Northern Rock, because Northern Rock had a very simple business model. It may have been the wrong business model, but it was a very simple one and therefore relatively easy to effect the change; but even in that case it took us a good period of time. So I think we have a much better grip of RBS than we had, as has the management, but it is still a fiendishly complicated organisation.⁹¹⁵

Stephen Hester told investors in February 2013 “The sooner we are privatised the better for the taxpayer and the better for us”.⁹¹⁶ A restructuring which could be completed in a shorter period than RBS’s existing 18-month plan would clearly be optimal. However, there is considerable uncertainty attached to the timing and outcome of this plan. A longer restructuring might still be worth doing if it provided more certainty and a better economic outcome, but significantly longer timescale would nevertheless weaken the case for action.

913 Q 4535

914 Oral evidence taken before the Treasury Committee on 26 March 2013, HC (2012-13) 1063, Q 386 [Sir Nicholas Macpherson]

915 *Ibid.* Q 387 [Sir Nicholas Macpherson]

916 Stephen Hester, *Annual Results 2012 Analysts Presentation*, 28 February 2013, <http://www.investors.rbs.com>

487. There is likely to be a potential trade-off between the time it would take to complete a restructuring and the cost and risk involved. Conducting a lengthy valuation and negotiation with shareholders would provide more security, but could drag the process out. Being willing to offer up more value to third parties or accept greater risk of legal challenge could speed the process, but there are limits to what would be economically and politically acceptable.

The cost of acting

488. One of the main perceived obstacles to a more radical approach for RBS is its potential cost. In considering this, it is important to distinguish between the real additional costs from taking a different approach and those costs which are already present but which may not be fully visible. There are several potential sources of real additional costs, most importantly:

- If minority shareholders are paid a premium;
- If assets are transferred to the bad bank at above their fair value (this is in effect also a way of paying the shareholders a premium, because they gain 18 per cent of any premium paid on the assets);
- If accelerating the sale of Citizens or the wind-down of the investment bank destroys value or results in opportunity costs;
- There are likely to be significant transaction costs from conducting the valuation and executing the restructuring.

489. These costs are difficult to estimate for several reasons. For example, it is possible that the assets in the bad bank might perform better than expected and that the restructured RBS would become highly profitable, in which case buying out the minority shareholders even at a premium could result in a net gain for the Government. Assuming there are costs, these might be deemed worthwhile in order to secure the potentially large wider economic benefits. RBS itself would be unable to justify the costs of radical structural reform as being in line with shareholder interests, but, as Stephen Hester acknowledged, there could be broader public interests which would override this:

Whether there is a public policy override is obviously not for us but when we have been asked to look at customer and shareholder risk, we come up, every time, with the route that we are on, painful as it might be, as being the best of the available routes.⁹¹⁷

490. Depending on the approach taken, there could also be a significantly larger apparent cost or contingent liability, for example from buying the assets in the bad bank or guaranteeing its debts. However, it is important to note that these do not necessarily represent an additional burden on taxpayers, but are simply a different way of accounting for existing commitments. The Government already owns 82 per cent of the equity in RBS.

It already bears 82 per cent of any losses up to the value of its equity stake. It could even be argued that, at least in the absence of a robust and well-tested bail-in regime, the Government would be likely to find itself forced to stand behind RBS's other liabilities in the event of a new crisis. Sir Mervyn King contended that accounting issues should not be allowed to stand in the way of action:

It inevitably means accepting that there are losses. Those losses are there anyway. The fact that if we just let this muddle through the losses are not realised, does not mean that the economic losses are not there. It is just that they do not show up as losses to the taxpayer given the normal conventions of public accounts.⁹¹⁸

491. The kind of restructuring under discussion would have an impact on the public accounts. The Government's ownership of RBS is already reflected in the ONS's measure of Public Sector Net Debt (PSND) so that the creation of a bad bank might not have a significant impact on that measure. However, the temporary financial interventions are excluded from the alternative measure PSNDex, which is the figure more commonly used to calculate the UK's debt to GDP ratio.⁹¹⁹ The liabilities associated with a bad bank might well count towards PSNDex, thus affecting UK's debt sustainability as recorded under this measure. For example, a £100bn bad bank could increase PSNDex from 75.4 per cent to 81.8 per cent of GDP if this all scored as additional PSNDex.⁹²⁰ Sir Mervyn King argued that markets would recognise this was an accounting change rather than a real worsening of the UK's fiscal position:

the financial markets do see through that; they realise that the losses out there at present don't go away just because we haven't recognised them in the accounts today. They are real losses, and it is better to face up to that [...] we should not worry about the consequential impact on the apparent scale of public debt.⁹²¹

However, there would be a significant risk to the UK fiscal position if markets did not react so calmly. As an illustration, the Office for Budget Responsibility estimate that, if gilt rates were to increase by 1 per cent, the Government's debt interest costs could increase by £8.1bn a year by 2017–18.⁹²²

State aid

492. An additional obstacle could come from EU law. This prohibits national authorities from granting State aid, defined as “an advantage in any form whatsoever conferred on a selective basis to undertakings”, except in carefully defined circumstances.⁹²³ The European

918 Q 4532

919 Office for National Statistics, Statistical Bulletin: *Public Sector Finances*, January 2011

920 Office for National Statistics, Statistical Bulletin: *Public Sector Finances*, March 2013

921 Q 4543

922 Office for Budget Responsibility, *Economic and Fiscal Outlook*, supplementary table 2.2

923 European Commission, *State Aid Control Overview*, ec.europa.eu

Commission put in place a special framework for the use of State aid for bank restructuring in response to the financial crisis.⁹²⁴ This pursued two linked objectives:

- i) supporting financial stability, by giving legal certainty to rescue measures taken by the Member States and promoting long term viability, and ii) safeguarding the internal market and a level playing field across banks.⁹²⁵

The Commission imposes restructuring requirements on banks in receipt of State aid in pursuit of the second of these objectives:

measures to limit competition distortion may include divestments, temporary restrictions on acquisitions by beneficiaries and other behavioural safeguards. These measures are designed not only to limit distortions between aided banks and those surviving and restructuring without State aid, and between banks in different Member States, but also to create conditions which foster the development of competitive markets after the crisis.⁹²⁶

RBS has already twice been the recipient of State aid in relation to the government interventions in 2008 and 2009, and it is likely that government intervention to take over its bad assets would be regarded as further State aid. RBS has still not completed its existing State-aid-mandated divestments, as we noted earlier. A third State aid intervention for RBS would therefore be expected to result in further restrictions, which could include additional divestments, limits on the amount of new lending RBS could undertake, or dividend restrictions. Onerous restrictions on the RBS good bank could undermine the objectives of restructuring by limiting RBS's ability to be a strong competitive lender and making a sale more difficult. The precise restrictions would be the subject of negotiations between the Government and the European Commission.

Full break-up

493. According to the OFT review of competition in retail banking in 2010, RBS provided 16 per cent of UK personal current accounts and 23 per cent of SME accounts, second only to Lloyds Banking Group.⁹²⁷ RBS already faces State aid requirements to divest 318 branches including 2 per cent of the UK retail banking market and 5 per cent of the UK SME and mid-corporate market, a process which has been delayed. A major restructuring of RBS could present an opportunity to review the divestment plan and further increase competition, potentially by returning the good bank to the private sector as multiple mid-sized banks rather than a single dominant firm. This could take the form of several national challenger banks, or regionally-focused banks. Such a split could also help to address state aid concerns arising from further intervention in RBS. Additionally, a split could take place

924 Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, Official Journal C 195, 19 August 2009

925 European Commission, *Restructuring banks in crisis—overview of applicable State aid rules*, European Commission Competition Policy Newsletter 2009-3

926 *Ibid.*

927 Office of Fair Trading, *Review of barriers to entry, expansion and exit in retail banking*, November 2010

on functional lines, creating a commercial/retail bank while disposing of the investment banking function.

494. The benefits of additional competition from creating challenger banks were explored earlier in this chapter. The benefit of creating regional banks could include greater focus and commitment towards local businesses and a rebalancing of the UK economy away from London. A recent report from the New Economics Foundation looked at “stakeholder banks” across various countries and concluded that one of the main benefits from institutions such as the German Sparkassen is that they “promote local economic development by consistent support for SMEs, preventing capital drain from rural areas and regions, and maintaining access to bank branches even in remote areas”. However, they did also note several concerns about stakeholder banks which contributed to their decline in the UK, such as “political interference and lack of accountability”, “inefficiency” and “distortion of competition”, pointing to some prominent recent examples of poor performance among German landesbanken and Spanish cajas.⁹²⁸ There are also financial stability risks associated with regional banks tied closely to regional economies.

495. There would be significant additional costs from a full break-up of RBS. These would fall on the Government, both as the majority owner and since it would probably be necessary to buy out or compensate minority shareholders in order to be able to act. The experience of RBS and Lloyds Banking Group in preparing existing divestments shows how difficult, expensive and time-consuming it can be to separate integrated activities and put new structures and IT in place. António Horta Osório stated that post-tax cost to Lloyds Banking Group of preparing the “Verde” divestment will be approximately £1bn.⁹²⁹

Conclusions

496. **The Government’s strategic priority for RBS must be to create strong and competitive provision of its core services, including UK retail and corporate lending, freed from its legacy problems. This is essential, not just for the SME and retail sectors that RBS primarily serves, but also in the interests of the broader economy as a whole. RBS and the Government claim to share these reflections. However, the Commission doubts that the current proposals will achieve this outcome sufficiently quickly or decisively.**

497. **The current strategy for returning RBS to the private sector has been allowed to run for five years. Progress has been made but it is time to look at this afresh. The case has been put to the Commission for splitting RBS into a good bank and bad bank. There may be significant advantages in doing so, including focusing the good bank on UK retail and commercial banking and, by freeing it from legacy problems, strengthening its ability to lend and making it a more attractive investment proposition which could subsequently be privatised at a good price. However, there are also important questions which need to be answered before such a course of action could be recommended. These questions include:**

⁹²⁸ New Economics Foundation, *Stakeholder Banks: Benefits of banking diversity*, March 2013

⁹²⁹ Q 3463

- The cost and risk to the taxpayer;
- What assets would go into the bad bank and what would be left behind in the good bank;
- The case for a wider split between retail and investment banking at RBS given the need to change the past culture at the bank;
- The potential State Aid consequences on the shape of RBS of a further injection of state funds in terms of divestments or other involuntary restructuring; and
- Whether or not such a course of action would be capable of returning the good part of the bank to the private sector more quickly than the course currently being pursued by the RBS management.

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

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

Lloyds Banking Group

500. Lloyds Banking Group (LBG) emerged from the merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) in September 2008 at the height of the financial crisis amid serious concerns that HBOS would collapse without some form of external support. Subsequently and as a direct result of the merger, the combined group now has the largest presence of any bank in the UK retail market. It has the largest single market share in most segments of the market, including personal current accounts, savings accounts, mortgages, unsecured personal loans and credit cards.⁹³⁰

501. Both Lloyds Banking Group and HBOS received considerable Government support during the financial crisis. The taxpayer injected £8.5 billion directly into HBOS, while Lloyds Banking Group received a further £12 billion. The total of £20.5 billion provided by the taxpayer to both groups was all channelled into supporting HBOS. As at the end of

930 Office of Fair Trading, *Review of barriers to entry, expansion and exit in retail banking*, November 2010

March 2012, the Government held a total of 27.6 billion ordinary shares in LBG equivalent to 40 per cent of total share capital. The average share price at which the Government invested in the various constituent parts of LBG was 73.6 pence. LBG's share price on 30 April 2013 was 54 pence—equivalent to an unrealised paper loss of approximately £5.6 billion. When calculated net of the fee paid for participation in the APS, the break-even price was 63.2 pence.⁹³¹

502. Lloyds Banking Group received other forms of taxpayer support. It participated in the Asset Protection Scheme, which was designed to provide protection against future credit losses on certain assets. Lloyds exited the APS in November 2009, instead conducting a rights issue in December 2009, Lloyds Banking Group paid a withdrawal fee to the Government of £2.5 billion, reflecting the implicit support it had received from the APS since March 2009.⁹³² LBG also benefited from participation in both the Credit Guarantee and Special Liquidity Schemes.

503. LBG was compelled to divest assets as a condition for EU approval of the Government support it had received. The LBG restructuring plan consists of the divestment of a retail banking business with at least 600 branches, a 4.6 per cent share of the personal current accounts market in the UK and up to 19 per cent of the Group's mortgage assets. The number of branches to be disposed of represents approximately 20 per cent of the LBG network. It was required to complete the divestment by 30 November 2013.⁹³³ LBG had agreed to divest these assets to the Co-operative Group, but the deal fell through in April 2013.

504. Unlike RBS which has had, and continues to have, a significant investment banking arm, LBG can be characterised as a retail and commercial bank. Mr Horta-Osorio confirmed that this would continue to be the case:

We said that we would be focussed on retail and SMEs and not on investment banking, trading, equities or exotic instruments. We have absolutely focussed the bank on delivering retail services and services to SMEs ⁹³⁴

Although not on the scale of RBS, LBG also has an international presence, but is now committed to being “totally focussed in the UK”. As Mr Horta-Osorio told us:

We had 30 countries internationally, we have committed to go from 30 to less than 15 in four years and, in 18 months, we have done 12 of the 15, so we are significantly ahead of plan.⁹³⁵

505. LBG has made considerable progress in terms of restructuring its business. In 2011, it returned to underlying profitability. In 2012, underlying profits rose from £638 million in 2011 to £2,607 million, although it ultimately made a statutory loss for the year primarily as

931 UK Financial Investments Ltd, *UK Financial Investments limited (UKFI) update on UKFI market investments*, March 2010, pp 6-8

932 *Ibid.*

933 Independent Commission on Banking, Final Report, September 2011, Box 8.1

934 Q 3414

935 Q 3414

a result of PPI provisions. At the same time LBG has taken steps to restructure the business through the reduction of non-core assets. As a result the LBG (non-core assets) balance sheet had fallen from £194 billion in 2010 to £98 billion in 2012. At the same time the bank has reduced its reliance on wholesale funding with a large reduction in the loan to deposit ratio from 154 per cent in 2010 to 121 per cent in 2012. Its capital ratio stood at 12 per cent at the time it announced its 2012 results.

506. Mr Horta-Osorio was bullish for Lloyds prospects for the future when he spoke at the LBG AGM on 16 May 2013:

We expect us [Lloyds] to return to profitability this year and to grow our core business, to realise our full potential to deliver strong, stable and sustainable returns for you, the shareholders, and to allow UK taxpayers' investment in the group to be repaid⁹³⁶

Lloyds share price subsequently rose to its highest level in over two years and is, on some measures, close to its break-even price.

507. It was subsequently reported by the media that “as the bank’s capital levels and profitability improve it [Lloyds] will seek permission from regulators to re-start paying dividends to shareholders, potentially next year”. The implications of renewed dividend payments were made clear:

That is seen as a key step on the road to privatisation as it shows the bank is healthy enough to give profits back to the owners instead of retaining them to strengthen its capital position.⁹³⁷

508. UK banks are now preparing to implement the Vickers recommendations on ring-fencing. The Treasury Committee heard that this would be a far greater challenge for RBS than Lloyds. Adam Young, Co-Head of Equity Capital markets, Rothschild, contrasted the impact on the two institutions:

The implementation of the Vickers report has a fairly significant impact on the way the investment banking and the corporate banking parts of the RBS business are perceived by the marketplace, because there is no absolutely clear view about how the implementation of that regime might affect management’s view of the economics of that business [...]

For Lloyds Banking Group the impact of Vickers is much less profound.⁹³⁸

509. When asked about what more LBG needed to do before they could be returned to the private sector, Manus Costello, bank analyst at Autonomous, sounded positive. He told the Treasury Committee that Lloyds were “in a different position from RBS”. This Mr Costello said was:

936 Lloyds Banking Group, *Annual Report and Accounts 2012: Becoming the best bank for customers*, March 2013, p 17

937 “Lloyds privatisation gets closer as share prices soar”, *City A.M.*, 17 May 2013, www.cityam.com

partly because of the size of the Government stake and partly because of the nature of the business model itself. They [Lloyds] have also made some good progress in reducing their funding risks. There remain a lot of risks surrounding the UK macro environment and the asset quality of some parts of their book and [...] over the course of the next couple of years they need to demonstrate that they can build their capital ratios and manage their way out of some of these non-performing exposures.

Crucially, Mr Costello added, “that is what they are on track to do”.⁹³⁹

510. Lloyds Banking Group is in a very different situation from RBS. The Government stake in the bank is far smaller and Lloyds appears to have made faster progress in terms of restructuring its business and returning to sustained profitability. To a large extent this ‘faster progress’ reflects the greater complexity of restructuring RBS, given its significant investment banking arm and international operations. Restructuring the business and returning to a path of sustained profitability has proved less difficult at Lloyds. It has successfully implemented the integration of HBOS and refocused on its core markets of commercial and retail banking. Lloyds appears to be increasing its lending to business.

511. Lloyds Banking Group has suffered far less from the effect of public ownership and the perception of political interference than RBS. Lloyds, a mainly retail and commercial bank, has also largely avoided the same intense public focus on remuneration policies. For these reasons the case for intervention in Lloyds is far weaker than is the case with respect to RBS. Lloyds appears better placed to return to the private sector without additional restructuring.

Financial literacy

512. The Commission heard a range of evidence on mis-selling and the complexity of financial products and services on which consumers must make decisions with consequences many do not, at the time, fully understand. We discuss below the role that banks and regulators can play in preventing this, but more informed consumers can also be empowered to challenge banks who try to mis-sell, contrary to their best interests. More importantly, financially literate consumers are able to exercise informed choice and impose market discipline on banks.

513. The UK has a poor track record when it comes to levels of literacy and, in particular, numeracy, as was demonstrated in the BIS *Skills for Life Survey*. The results showed that, in 2011, only 22 per cent of the working-age population in England (7.5 million adults) reached Level 2 or above in numeracy—roughly equivalent to attainment at A*-C at GCSE—compared with 57 per cent of the population (19.3 million adults) in literacy. The corresponding figures for 2003 were 26 per cent (8.1 million adults) for numeracy and 44 per cent (14 million adults) for literacy. Furthermore, 17 million adults in England (just under half the working-age population) are at ‘Entry Levels’ in numeracy—roughly equivalent to the standards expected in primary school.⁹⁴⁰

939 Oral evidence taken before the Treasury Committee on 15 May 2012, HC (2012–13) 73, Q 7

940 Department for Business Innovation and Skills, *BIS skills for life survey*, 13 December 2012

514. We examined the consequences of low levels of numeracy and financial literacy on competition and consumer outcomes in the retail banking sector. Martin Lewis, the TV pundit, has made explicit the link between low levels of consumer financial literacy, poor consumer outcomes and PPI mis-selling:

Right across society, we struggle from genuine consumer illiteracy, if I can take the broadest term possible, where I would say 60 per cent to 70 per cent of the population simply do not understand many of the products that we have [...] I am dealing at the moment with a £9 billion payment protection insurance mis-selling scandal.

If you want evidence of the size of this and the sheer tiny amount of money that we are talking about here that would make a big difference in terms of financial education, let us start with that one. An entire nation of millions of people who were conned or mis-sold into getting an insurance product that was often worthless for them and at best was hideously expensive.⁹⁴¹

A number of witnesses identified a lack of financial literacy as a factor in customers not receiving the best service they could. Sue Edwards of Citizens Advice told us that the issue was broader than the need for mathematical skills: “There is a case for better financial skills throughout the population—not just financial skills, but how to be a savvy consumer. We are trying to play a part in educating people about how to use financial products and services safely and fairly”.⁹⁴² A Regional Director for Lloyds also identified financial literacy as a problem:

I think financial literacy is an issue with potentially quite significant implications if we do not do something about it. We know that we have a population that is broadly undersaved and underprotected, and will not have great retirement plans. I do not say that that is entirely due to financial literacy, but it can only get worse unless we do something about it.⁹⁴³

The Chief Executive of Lloyds, however, spoke of the benefits if literacy could be improved:

If you have more informed consumers with more transparent products, and they have a choice, that creates a virtuous circle exactly because competition is good for improving quality standards. I believe that when you have greater competition, that is a powerful incentive for all providers in any industry to improve their standards. Therefore, the more informed customers are, and the more competition you have, the better that is for quality standards in general.⁹⁴⁴

515. The former Financial Secretary to the Treasury, Mark Hoban MP, also spoke of the importance of increasing consumer financial literacy in evidence to the Joint Committee on the Draft Financial Services Bill, when he said that:

941 Uncorrected transcript of oral evidence taken before the Treasury sub-committee on 13 June 2012, HC(2012–13) 271-i, Q 62

942 JQ 22

943 AQ 619

944 Q 3403

One of the aspects of my role which I least enjoy is looking at letters from colleagues where, clearly, consumers have not understood the products that have been sold and have not understood the full risks. That is not a very satisfactory outcome for either the industry or the consumer and there should be much more emphasis on ensuring that consumers understand it. That is why I am very supportive of financial capability. You cannot just rely upon firms to do this. You need to ensure that consumers have support to understand those products.⁹⁴⁵

516. The Joint Committee, however, noted that “financial education is a long-term process, and we are unlikely to see improvements in the short-term”.⁹⁴⁶ Peter Vicary-Smith agreed, calling improving financial literacy “a long-term game plan”.⁹⁴⁷ There is therefore a case for focusing resources on improving the financial education young people receive. In its written evidence to the Commission, pfeff note that “prevention is better than cure”, and advocate financial education for young people in schools. It argues that this will “build a generation of empowered customers able to deal with financial challenges”.⁹⁴⁸ The Treasury Committee has also had a long-standing interest in this area. Its report on the Financial Conduct Authority stated that “the FCA and the MAS should work with the Department for Education to help ensure that young people receive at school the basic learning tools and skills required to make sense of financial advice later in life”.⁹⁴⁹

517. Earlier this year, the Government announced the inclusion of personal finance education in the new draft National Curriculum for maths and citizenship, making financial education compulsory in secondary schools for the first time from September 2014. The curriculum for citizenship should “prepare pupils to take their place in society as responsible citizens by providing them with the skills and knowledge to manage their money well and make sound financial decisions,” while the maths curriculum will include financial mathematics.⁹⁵⁰ This reflects the cross-curricular approach recommended by pfeff and in a recent report by the APPG on financial education for young people.⁹⁵¹ However, the APPG also concluded that “in primary schools the current cross-curricular approach should continue but it is important that primary school teachers are fully equipped to teach basic maths and money skills in order to lay the foundation for secondary education.” pfeff also noted that it was important to measures were needed to ensure that all financial education programmes “result in [...] sustained behaviour change.

518. In addition to lessons provided by schools, financial education is funded or delivered by external organisations. The APPG on Financial Education for Young People reported that:

945 Oral evidence taken before the Joint Committee on the Draft Financial Services Bill on 15 November 2011, Q1071

946 Joint Committee on the draft Financial Services Bill, First Report of Session 2010–12, *Draft Financial Services Bill*, HC 236/HL 1447, para 123

947 JQ 22

948 S117

949 Treasury Committee, Twenty-sixth Report of Session 2010–12, *Financial Conduct Authority*, HC 1574, p 53

950 Department for Education, *The National Curriculum in England: Framework document for consultation*, February 2013, p 149

951 All-Party Parliamentary Group on Financial Education for Young People, *Financial Education & the Curriculum*, December 2011

Outside organisations have the potential to boost the teaching of personal finance education in schools. However, schemes must be quality checked and it is clear that there is no capacity for it to be delivered universally by providers. A Quality Mark would ensure that teaching resources are linked into the current curriculum and that organisations do not market financial products or services.”⁹⁵²

Pfeg also reiterated that “it is essential that [financial education] is led by teachers and supported by a comprehensive and progressive curriculum”, and cited its own Quality Mark scheme, which currently kitemarks the majority of banks’ financial education resources for use in schools, as “best practice”.⁹⁵³

519. Waves of mis-selling and other forms of detriment suffered by consumers in the retail banking market reflect not just widespread financial illiteracy, but may also be the result of weaknesses in numeracy and literacy skills of some consumers. Wider concerns about the need for higher numeracy and literacy skills fall outside the scope of our inquiry, but they have contributed to poor levels of financial literacy. A more financially literate population will be better capable of exerting meaningful choice, stimulating competition and exerting market discipline on banks, which, in turn, can drive up standards in the industry. Greater financial literacy can also contribute to social mobility. Industry, regulators and governments must avoid a situation where the banks design ever more complex products and then blame consumers for not being financially literate enough to understand them. Alongside greater financial literacy, there is a need for a relentless drive towards the simplification of products and the introduction of clear, simple language. Mis-selling and undesirable cross-selling are very unlikely to be eliminated through higher financial literacy, but improvements to such literacy will help bear down on those problems and be more effective, in many cases, than ever more detailed conduct regulation. The counterpart of irresponsible lending is, in many instances, uninformed consumers. Regulation remains essential, but risks restricting choice and innovation. Increased competition, underpinned by financially literate consumers, can do much more to address irresponsible lending. To this end, we welcome the announcement by the Government earlier this year that it will include both financial education and financial mathematics in the National Curriculum.

Complaints and redress

Small business access to the Financial Ombudsman Service

520. EU legislation sets out the rights and obligations relating to the provision of payment services.⁹⁵⁴ It provides that member states must put in place an adequate and effective out-of-court complaint and redress procedure for the settlement of disputes between payment service users and payment service providers. The adequate and effective out-of-court

952 All-Party Parliamentary Group on Financial Education for Young People, *Financial Education and the Curriculum*, December 2011, page 28

953 Ev 1281

954 European Directive 2007/64 on Payment Services, 13 November 2007m eur-lex.europa.eu

redress procedure used in the UK is the Financial Ombudsman Scheme (FOS) established under Part 16 of the Financial Services and Markets Act 2000 (FSMA).⁹⁵⁵ The question as to whether the FOS has jurisdiction to hear a case is left to rules made by the FCA.⁹⁵⁶

521. The route of complaining to the Financial Ombudsman Service (FOS) is open to narrowly-defined micro-businesses. Sir Nicholas Montagu, Chairman of the Board of the Financial Ombudsman Service, explained this in a letter to the Treasury Committee:

[...] It is important to note that our remit in respect of these cases is constrained. First because of the limit on our awards – now £150,000 (but until recently £100,000). Second, because we are unable to consider cases from businesses unless they are defined as micro enterprises (a new definition introduced in 2009). That means a firm must both have an annual turnover of up to €2 million (approx. £1.67 million) and have fewer than 10 employees. Practically therefore our remit seldom encompasses the larger business loans I believe are at the heart of the reported concerns.⁹⁵⁷

This means that some small firms unsatisfied by redress offered by their bank for interest rate derivative mis-selling may only have the expensive court route open to them. During a Commission Panel visit to Birmingham, SME owners expressed concern that this limit was unfairly preventing some very small businesses pursuing redress.⁹⁵⁸

522. Natalie Ceeney told the Treasury Committee that the FOS was open to a consultation on the possible limited expansion of its remit for the purposes of complaints about interest rate derivatives:

From what we have heard, though, a lot of the firms we are talking about would be outside our limit, which is one of the reasons why we have been exploring with the FSA whether we extend our jurisdiction specifically for a swap scheme. As I mentioned, we have said to the FSA that if they want us to do that, we are up for consulting on doing so.⁹⁵⁹

After that evidence session, the FSA revised the size criteria of firms that will be eligible for inclusion in its review into interest rate swaps. The definition of customers to be included had become so complicated that the FSA published a flowchart in an attempt to explain which firms are and are not eligible for their scheme.⁹⁶⁰ However, the FSA did not choose to consult on a change to the criteria for access to the FOS. Natalie Ceeney stressed that the FOS had not been lobbying for such a change:

955 Financial Services and Markets Act 2000, Amendments to Part 16 made by Schedule 6 to the Payment Services Regulations (S.I. 2009/209) provide that complaints can be brought to the FOS for the actions of a payment service provider.

956 Financial Services and Markets Act 2000 s226; PRA and FCA Handbook, DISP, fshandbook.info

957 Letter from Sir Nicholas Montague to the Chair of the Treasury Committee, 28 March 2012, available at www.parliament.uk

958 Members of Sub Committee A: Panel on the consumer and SME experience of banks visited Birmingham on 24 September 2012 to attend an event organised by Which?

959 Uncorrected transcript of oral evidence taken before the Treasury Committee on 30 October 2012, HC (2012-13) 701, Q 46

960 FSA, Internal Revenue Service Flowchart, www.fsa.gov.uk

We offered, if it was helpful, to run it, and that if it wasn't, we wouldn't. It was a completely neutral offer, and we do not have a view. We were set up by Parliament to consider complaints; it is really up to others to set our jurisdiction.⁹⁶¹

Other witnesses drew attention to the problems with any line drawn to determine eligibility. Tony Boorman told us that “drawing legal lines across the rich tapestry of small businesses, medium-sized businesses and how they have interacted over many years on this particular topic is a genuinely difficult task”.⁹⁶²

523. The narrow definition of an “unsophisticated customer” used to determine eligibility for access to the Financial Ombudsman Service (FOS) for redress has been highlighted as problematic by the wave of cases relating to interest rate swap mis-selling to small businesses. Many small businesses have fewer than 10 employees. Such businesses are particularly vulnerable to potential exploitation by the banks they rely upon for finance, particularly in the case of complex derivative products. The Commission recommends that the FCA consult on options for widening access to the FOS.

The industry's approach to PPI complaints management

524. Every six months, the FOS publishes a range of firm-specific statistics relating to customer banks' complaints. One of the most important of these statistics relates to the FOS' uphold rate in favour of customers. A high uphold rate by the FOS in favour of a customer could be seen as indicative of multiple failings of the bank on behalf of a customer as this represents not only poor levels of complaint handling service at the bank, but also poor service standards in relation to the nature of the root cause of the customer's complaint itself. PPI complaint uphold rates across the industry are currently much higher than is the case with respect to other financial products such as home finance and pensions. The latest FOS statistics, for the period of 1 July to 31 December 2012 show the following extremely high PPI uphold rates: for example, Black Horse (part of Lloyds Banking Group) 97%, CitiFinancial (part of Citibank) 94% and HFC (part of HSBC) 83%.⁹⁶³

525. We questioned bank executives from Barclays on the high uphold rate in favour of consumers and asked Mike Walters to explain why, over the past two years, the Financial Ombudsman Service has upheld about 40% of complaints against Barclays. Mr Walters, Head of Compliance at Barclays, acknowledged that this 40% figure was “far too high”, but suggested that this was the case because “the numbers are informed by the PPI problem”. However, we put to Mr Walters that the 40% figure stripped out PPI and was far higher when PPI is included. Again, when pressed on why the high uphold figures have been persistently high over a long period of time, Mr Walters told us that “they have been too high for a long time at Barclays and across the industry”. He added that Barclays had “put

961 JQ 690

962 JQ 686

963 Financial Ombudsman Service, *Complaints Data – showing individual financial business*, www.ombudsman-complaints-data.org.uk

in place a specific programme to look at this problem. This is something that our chief executive is very focused on”. Natalie Ceeney told us that customers’ increased use of claims management companies for PPI resulted from a lack of trust in how the banks had approached PPI mis-selling in general:

unfortunately the lack of trust in banks that the whole episode had fuelled then fuelled the claims management industry, which piled in, saying, “You obviously can’t trust the banks, here’s us.” So it left us in a much bigger mess than before.⁹⁶⁴

526. We examined the issue of a time bar for PPI complaints, which the BBA has been pushing for, as well as how best to ensure that all those affected by PPI mis-selling are contacted and given an opportunity to complain. Natalia Ceeney told us that it was “helpful [...] that the FSA board has made a statement that it will only introduce a time bar if it is in the consumer interest, which I think is a very important statement”. She said that there were:

a few things that I think are important for the FSA to think through, and we have absolutely said this to the FSA. The first thing that I would say is that I think one of the myths around at the moment is that there are no time limits; of course there are. There are current time limits, which are three years from the point you are individually aware that there is a problem, or six years from the sale [...]

there are some challenges particularly with PPI, because of the level of assumptive selling. Everybody in the UK might be aware that there is this thing called PPI, but would you individually necessarily know that you were sold PPI? You may or may not know—in fact, we have come across a lot of people who did not, because of the way that it was sold. That’s the first thing.

527. So there are already time limits. One of the first questions that needs to be asked is why are those current limits inadequate? Bringing in a new time limit would suggest that they are, but they seem to work for everything else. The second question, I think, is whether or not the endowment experience actually offers a helpful precedent. You will remember that, in mortgage endowments, a time limit was brought in; it was actually brought in to extend consumer rights, not to limit them. To go back to my assumptive selling point in a way, in mortgage endowments, importantly, every customer was written to a number of times. That took it from a general issue about there being mis-selling of mortgage endowments down to the individual level of each consumer knowing where they stood.

528. At the moment in PPI, we are a long way from each consumer knowing where they stand. If a time bar is brought in, there will certainly be a challenge about how we deal with the issue of people being aware of PPI but not necessarily being aware of where they stand individually.

529. The large banks have a poor track record when it comes to complaints handling. This is clearly demonstrated by the high uphold rate by the Financial Ombudsman Service, especially when it comes to handling customer complaints regarding PPI. This

is unacceptable and has clearly contributed to customers lack of trust in banks. The Commission expects to see a significant improvement in bank performance in this area.

530. A line will eventually need to be drawn under the PPI debacle, but that line will need to be drawn carefully and in a way that ensures that consumers do not lose out unfairly. Consumers require clarity about whether or not the PPI mis-selling scandal may have affected them personally. To deliver this clarity, the Commission recommends that the FCA urgently consider again the case for requiring banks to write to all identified customers, except those who have already initiated a PPI complaint or been contacted as part of any discrete FSA-led PPI process in the past, and report to Parliament on the outcome of its considerations.

Handling fees for complaints

531. The FOS is intended to act as a last resort for customers who feel their complaint has not been properly addressed by their bank. The FOS is free for eligible customers and claims management companies acting on behalf of bank customers, but a bank must pay a case fee for almost every complaint the FOS receives from its customers even if the FOS finds that the bank handled the customer's complaint appropriately. This case fee is £550 (with the first 25 cases for a firm being free of charge), although PPI complaints incur an extra £350 charge. In addition to automatic case fees, firms who are obliged to provide customers with FOS access are charged a pre-set levy which is agreed on annually following an FCA consultation process⁹⁶⁵. There is a risk that, under the current arrangements, banks may have an incentive to not take consumer complaints seriously in the expectation that consumers will then go to the FOS or because they expect consumers in any case to use the FOS or claims management companies to handle their complaints. This is because it may save costs and reduce administrative burdens on banks. When asked whether this was indeed the case, Mike Walters told us that was "really not right".

532. The evidence the Commission has received suggests that too often the banks have not taken customer complaints seriously. Many banks have had very high percentages of their complaints upheld by the FOS for far too long. The Commission recommends that the regulators consider this as a matter of urgency. This needs to change with banks motivated to respond to complaints appropriately the first time round. The Commission believes that one way to incentivise this behaviour would be for the FOS case handling fee not to apply to banks where the FOS finds that the bank has managed a customer's complaint fairly in the first instance. Conversely, banks who are found not to have handled a complaint appropriately would face a higher case handling fee. The Commission recommends that the regulators consider this as a matter of urgency.

Transparency in wholesale and investment banking

533. In its January 2011 market study into *Equity underwriting and associated services*, the OFT found "little or no competition at the time of the transaction".⁹⁶⁶ It made a series of

965 Financial Ombudsman Service, *A quick guide to funding and case fees*, www.ombudsman-complaints-data.org.uk

966 Office for Fair Trading, *Equity underwriting and associated services, an OFT market study*, January 2011

recommendations to companies and institutional shareholders designed to apply greater pressure on equity underwriting fees. There is limited evidence of changes in company or shareholder behaviour in the light of the OFT report. This may partly be due to low levels of capital-raising given the wider economic climate. The IMA said that “it is not obvious these recommendations have been fully endorsed”.⁹⁶⁷ However, the Association of Corporate Treasurers (ACT) said that “shareholder pressure has been noted” and the ABI said that such pressure “has helped improve corporate decision-making around whether and how to undertake transactions and associated capital raisings and to achieve cost-effective outcomes for the company”.⁹⁶⁸

534. The Investment Management Association said that it was the responsibility of customers to ensure they were receiving good value for money in investment banking:

is incumbent on a company as part of its governance process to review its relationships regularly to determine that it is getting value for money. Shareholders have a role to play in satisfying themselves that issuers are properly implementing this process.⁹⁶⁹

The ABI⁹⁷⁰ and ACT⁹⁷¹ came to similar conclusions in their evidence.

535. Transition management, the process by which asset managers hire a custodian bank to aid in the liquidation or moving of a large portfolio of securities, has recently come under increased regulatory scrutiny. This follows allegations that State Street, which has a transition management arm, overcharged Ireland’s state pension fund as well as several large UK corporate pension schemes. It was reported by *The Financial Times* in May 2013 that “the FCA is currently investigating allegations that several pension funds were overcharged by State Street’s transition managers, although no formal enforcement proceedings have been brought”, but that, in addition, “the regulator has already requested detailed information from a variety of organisations connected to the service, suggesting that the entire industry can face a fresh bout of scrutiny over the issue”.⁹⁷² The FCA has been reported noting the risk that “unclear fee structures” lead to adverse outcomes for investors.⁹⁷³

536. Cross-selling and a lack of price transparency are not restricted to retail banking. Parts of investment banking are also characterised by opaque fee structures and some highly sophisticated companies have entered into complex transactions that they have not fully understood. This should not usually be an area for regulatory intervention: the principle of *caveat emptor* acts as an important force for market discipline. The regulator should not seek to shield sophisticated customers from the consequences of their poor decisions. However, it should be their duty, wherever possible, to ensure

967 G Ev 41

968 G Ev 27

969 G Ev 40

970 G Ev 18

971 G Ev 26

972 “UK watchdog swoops on big banks”, *The Financial Times*, 9 May 2013, www.ft.com

973 *Ibid.*

maximum price transparency at every level of banking. The lack of this transparency appears to be a problem even for sophisticated end users of, for example, transition management services.

6 A new framework for individuals

The contribution of governance

537. The previous chapter considered the extent to which the problems of standards and culture in banks can be tackled through the improved operation of the market. This chapter, and the subsequent two, considers the degree to which those problems can be addressed through changes to the governance of banks, supported where necessary, by oversight. This chapter considers the current and possible future frameworks for individuals working within banks. Chapter 7 examines the formal collective structures within banks for their governance and control, and the more informal elements in play in helping to determine standards and culture in banks. Chapter 8 considers remuneration.

Taking individual responsibility

538. Chapter 3 examined the extent to which the underlying problems of standards and culture could be attributed to the structures and incentives affecting the behaviour of individuals. A common thread of that analysis was a pervasive sense, reinforced by much of the evidence, that a culture exists in banking which diminishes a sense of personal responsibility. The Commission expressed concern, in particular, about the “accountability firewall” which seems to have developed to prevent those in senior positions having a strong sense of personal engagement with and responsibility for failings and misconduct within their line of management. The collective nature of official decision-making has also served to insulate individuals from a sense of individual responsibility. We also noted that the ties of professional identity, which can serve to inculcate a sense of pride and personal responsibility, were not as strong in banking now as in the past or as in some established professions.

539. Regulatory oversight of the banking sector is principally exercised through a relationship with firms, founded on the powers of authorisation, as considered in Chapter 9. There also exist mechanisms for regulatory engagement with individual bankers. This chapter first considers the principal framework for such engagement—the Approved Persons Regime (APER)—and its effectiveness. It then examines the role played, and that could be played, by professional bodies, drawing in part on evidence relating to professions such as medicine, accountancy and law. Finally, it sets out conclusions and recommendations on a new framework.

The Approved Persons Regime

Overview

540. Regulators have the power to require certain individuals within banks to seek pre-approval from the regulator before taking up their positions. Such individuals are known as “Approved Persons” and the arrangements under which they are approved are referred to as the Approved Persons Regime (APER).

The statutory framework for approval

541. The statutory framework for approval can be summarised as follows:

- The regulators specify certain functions within a financial services entity (such as a bank) as “controlled functions”;⁹⁷⁴
- The bank concerned applies to the regulators for approval for a named individual to carry out a particular controlled function or functions;⁹⁷⁵
- The regulators decide whether to grant the approval based on consideration of whether the candidate is “a fit and proper person” to perform the function to which the application relates, subject to a right of appeal;⁹⁷⁶
- The regulators may withdraw approval of a person as “fit and proper”, subject to appeal, and impose penalties on individuals who carry out controlled functions without approval;⁹⁷⁷ and
- The regulators can issues statements of principle, adumbrated in codes of practice, relating to the conduct expected of persons approved to carry out controlled functions (“Approved Persons”).⁹⁷⁸

The controlled functions

542. Under the Financial Services and Markets Act, the controlled functions that require individuals to become Approved Persons can be of two types:

- A “significant-influence function” (SIF), which means a function “that is likely to enable the person responsible for its performance to exercise a significant influence on the conduct” of the affairs of the authorised entity;⁹⁷⁹
- A “customer-dealing function”, which means a function that will involve the person performing it in dealing with the bank’s customers or the property of the bank’s customers “in a manner substantially connected with the carrying on of a regulated activity”.⁹⁸⁰

543. There are 9 Significant Influence Functions directly relevant to banks, which are shown in the table below.⁹⁸¹

Ref	Controlled Function
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974 Financial Services and Markets Act 2000, section 59

975 *Ibid.*, section 60

976 *Ibid.*, sections 61 and 62

977 *Ibid.*, sections 63 to 63D

978 *Ibid.*, section 64

979 *Ibid.*, section 59(7B)

980 *Ibid.*, section 59(7A)

981 Financial Conduct Authority, *Controlled Functions*, www.fca.org.uk

CF1	<i>Director function</i>
CF2	<i>Non-executive director function</i>
CF3	<i>Chief executive function</i>
CF8	<i>Apportionment and oversight function</i>
CF10	<i>Compliance oversight function</i>
CF10A	<i>CASS operational oversight function</i>
CF11	<i>Money laundering reporting function</i>
CF28	<i>Systems and controls function</i>
CF29	<i>Significant management function</i>

544. These functions are a mixture of positions (Director), generic responsibilities (compliance oversight) and specific responsibilities (money laundering reporting). The list of functions has evolved over time. For example, the FCA announced proposals in December 2012 to create two additional controlled functions in response to LIBOR manipulation: one a “benchmark administration function” (CF50), being the individual overseeing the team responsible for calculating and corroborating daily benchmark submissions; and the other a “benchmark submission function” (CF40), being the individual managing the team responsible for LIBOR submissions. The introduction of CF40 and CF50 took place from 2 April 2013.⁹⁸² It is illustrative of the complexity of the regime that the FCA themselves provide conflicting information on the categorisation of these new functions: the FCA handbook defines them as SIFs,⁹⁸³ whereas the FCA website describes them as neither SIFs nor Customer Dealing Functions but a completely separate category called “LIBOR functions”.⁹⁸⁴

The approval process

545. Where a bank identifies that a person is to undertake a function or functions bringing them within the APER, they make an application to the regulator. The regulators have regard to a number of criteria when assessing the fitness and properness of Approved Persons, the most important of which are (i) honesty, integrity and reputation, (ii) competence and capability and (iii) financial soundness.⁹⁸⁵ The regulator has a statutory obligation to determine applications within three months. However, the FSA committed to try to complete the processing of 85 per cent of applications within five (for customer function) or ten (for SIF) working days of receipt, depending on the nature of the application.⁹⁸⁶ For those in Significant Influence Functions, the regulator may conduct

982 FSA, Consultation Paper 12/36, *The regulation and supervision of benchmarks*, December 2012

983 PRA and FCA Handbook SUP 10A.4. www.fshandbook.info

984 Financial Conduct Authority, *Controlled Functions*, www.fca.org.uk

985 PRA and FCA Handbook, FIT, www.fshandbook.info

986 FSA, *Approved persons – Approval process*, www.fsa.gov.uk (this refers to the archived FSA website)

interviews in order to assess the technical experience of the applicant, a system introduced since the onset of the financial crisis in 2007.⁹⁸⁷

The Statements of Principle for Approved Persons

546. The Approved Persons Regime serves in part as a mechanism for establishing standards of conduct for individuals working in banks. Once approved, an Approved Person is subject to the regulatory Statements of Principle for Approved Persons which are set out below.⁹⁸⁸

There are seven Statements of Principle (of which Statements of Principle 1 to 4 apply to all Approved Persons and Statements of Principle 5 to 7 apply only to those performing Significant Influence Functions):

- an Approved Person must act with integrity (Statement of Principle 1);
- an Approved Person must act with due skill, care and diligence (Statement of Principle 2);
- an Approved Person must observe proper standards of market conduct (Statement of Principle 3);
- an Approved Person must deal with the FSA and other regulators in an open and co-operative way and disclose appropriately any information of which the FSA would reasonably expect notice (Statement of Principle 4);
- an Approved Person must take reasonable steps to ensure that the business for which he is responsible is organised so that it can be controlled effectively (Statement of Principle 5);
- an Approved Person must exercise due skill, care and diligence in managing the business of the firm for which he is responsible (Statement of Principle 6); and
- an Approved Person must take reasonable steps to ensure that the business of the firm for which he is responsible complies with regulatory requirements imposed on that business (Statement of Principle 7).⁹⁸⁹

547. An accompanying code of practice defines in more detail what is meant by the principles.⁹⁹⁰ These Principles for Approved Persons are designed to dovetail with the 11 Principles for Business which apply to the regulated entities themselves. These were developed to serve as “a general statement of the fundamental obligations of firms under the regulatory system”, and cover similar issues such as acting with integrity and due skill care and diligence, treating customers fairly, avoiding conflicts of interest and dealing with regulators in an open and cooperative way.⁹⁹¹ Individuals carrying out significant influence

987 PRA, *The Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 21

988 FSA, *Statements Of Principle And Code Of Practice For Approved Persons Instrument 2001*, 15 November 2001, APER 4

989 PRA and FCA Handbook APER 2.1, www.fshandbook.info

990 PRA and FCA Handbook APER 4.1, www.fshandbook.info

991 PRA and FCA Handbook PRIN 2, www.fshandbook.info

functions have an obligation under Statement of Principle 7 above to ensure that businesses for which they are responsible comply with the Principles for Business.

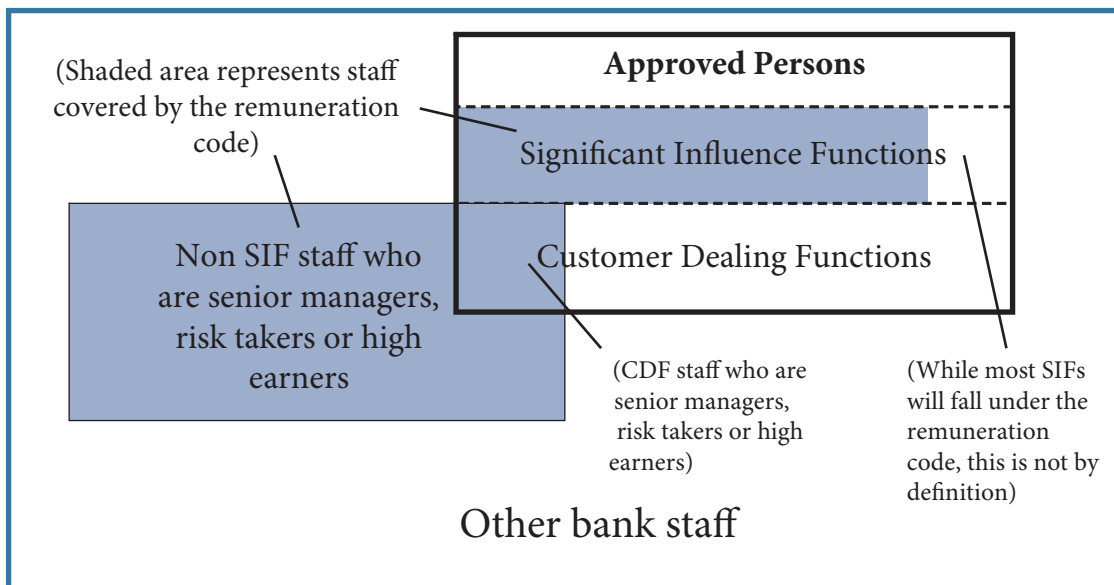
Relationship to the Remuneration Code

548. The Approved Persons Regime is separate to the system of “code staff” to whom the Remuneration Code applies, although confusingly there is a high degree of overlap. We describe the Remuneration Code in more detail in the following chapter. The FCA/PRA Handbook sets out that:

Remuneration Code staff comprises categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm's risk profile.⁹⁹²

In practice code staff will therefore include any individuals who hold significant influence functions under the Approved Persons Regime, even though there is no explicit link with the Approved Persons Regime functions. The Remuneration code also covers other individuals who are not SIFs, where they are material risk takers or high-earners (so for example star traders). The overlapping and circular definitions highlight the complexity and confusion of the current regimes, which are illustrated in simplified form in the figure below:⁹⁹³

Coverage of different regulatory regimes for individuals



992 PRA and FCA Handbook SYSC19A.3, www.fshandbook.info

993 Analysis based on PRA and FCA Handbook

The table below shows information obtained from the PRA on the number of individuals covered by the Approved Persons regime and the remuneration code in the largest 19 banking groups operating in the UK.⁹⁹⁴

	Number of individuals
In the Approved Persons regime	26,575
Of which, Significant Influence Functions	1,180
Of which, Customer Dealing Functions	25,395
Covered by the remuneration code	2,743

What's wrong with the Approved Persons Regime

A narrow scope

549. The table above shows that only a relatively small proportion of the 450,000 or so people working in banks in the UK are subject to the Approved Persons Regime. The numbers in the table reflect only staff in the largest 19 banks, but other estimates of how many bankers are in the Approved Persons Regime suggest that coverage is still likely to be less than 10 per cent overall.⁹⁹⁵ The Approved Persons regime covers those at the top of the organisation, a few specific functions at the next rung down, and then a wider population (often several rungs down) who deal directly with clients. It therefore misses out a number of groups who might nevertheless play important roles in banks and contribute directly or through weak supervision and control to both prudential and conduct failures in standards.

550. Inclusion within the Approved Persons Regime is the foundation of many elements of the enforcement regime described in Chapter 10. The Statements of Principle only apply to bank staff who are Approved Persons,⁹⁹⁶ and in consequence the majority of bank staff who are not Approved Persons cannot be the subject of enforcement action for departure from those principles. The regulators can only use their full range of enforcement powers against individuals who are Approved Persons. In the case of individuals outside the Approved Persons Regime the only available sanction (apart from distinct offences such as insider trading or money laundering) is a prohibition order which prevents an individual from undertaking any regulated activity. It is harder to justify exercise of this severe power because an extended set of criteria needs to be met.⁹⁹⁷ Anthony Browne told us

an awful lot of people in banks are not part of the Approved Persons Regime and so do not fall subject to its sanctions. For example, the people who submit LIBOR data

994 C Ev 175

995 Ev 782

996 Ev 92

997 PRA and FCA Handbook, Enforcement Guide, Chapter 9.18, www.fshandbook.info

and the people who are trading on the back of LIBOR data would not have been part of the Approved Persons Regime. That is why we said that one of the first things that we think needs to be looked at is expanding the regime to cover the sort of people you would expect to be covered by it and make it more public and visible.

551. Some individuals involved in LIBOR manipulation are being investigated by the Serious Fraud Office for possible criminal offences, and the FCA is also continuing its investigation into individuals. Neither have yet confirmed what action will be taken. However, Martin Wheatley confirmed that the scope of the Approved Persons Regime was one of the factors inhibiting their ability to take action:

One of our problems—LIBOR was a good example—was that for the set of people we wanted to take action against we did not have an Approved Persons Regime, which meant that it became more complicated for us to take action.⁹⁹⁸

Tracey McDermott also acknowledged that, if more individuals who were aware of LIBOR manipulation—as opposed to just those directly involved—had been covered by the Approved Persons Regime, it might have been possible to bring action against them for breaching Principle Four which requires that they “must disclose appropriately any information of which the FSA would reasonably expect notice”.⁹⁹⁹

552. The scope of the Approved Persons Regime is restricted in part because it is attempting to fulfil two, quite distinct, functions. On the one hand, it is the route through which bankers have to abide by the Principles and can be subjected to enforcement action for a breach, which would suggest that it should have fairly broad coverage. On the other hand it is a pre-approval mechanism for verifying the fitness and competence of bank staff. Since this can be a burdensome and resource-intensive process, there is therefore a case for restricting it to only those performing key roles. It should be noted that the regulators already recognise that not all people within the Approved Persons Regime need the same level of pre-approval. Individuals performing customer-dealing functions are treated differently from those performing significant influence functions, and Martin Wheatley told us that even many SIFs are no longer interviewed:

we have pulled back from the number of what we call significant influence function interviews—SIF interviews—and we do not do as many now as we were doing. We would still do them for the roles that are absolutely critical—obviously, the chief executive and the finance director are important jobs in important institutions—but we do not do them for other non-executive posts, or for other roles that we think are not quite so critical.¹⁰⁰⁰

Absence of individual responsibility

553. The regulators acknowledged that the existing regime is ineffective in identifying responsibilities within banks of significance when things go wrong. The FSA referred to

998 Q 4498

999 Q 3062; PRA and FCA handbook APER 2.1A, www.fshandbook.info

1000Q 273

“unclear, complex and confusing allocation of responsibilities amongst SIF holders”.¹⁰⁰¹ Tracey McDermott suggested that the low number of enforcement cases against senior managers in large banks was “partly to do with the problems of complexity in structures and a lack of clarity in structures about which senior management are directly responsible for individual decisions”.¹⁰⁰² The FSA wrote:

The allocation of individual responsibility within some firms for specific areas of conduct is not always clear and, in some cases, this has been an important factor in no significant influence function (SIF) holders being held to account when things have gone wrong.¹⁰⁰³

The FSA added that it has proved difficult to bring cases against individuals in large organisations in part because

It is unclear who was responsible for a decision (or series of decisions) because lines of accountability are unclear or confused, or because they pass, at some point, through people who are not approved (and are not required to be).

554. The FSA has already taken action to clarify responsibilities in one specific area, when in October 2011 it required medium and large firms to appoint a new senior manager function—the client asset oversight function (CF10a). In proposing this, the FSA explained:

At many of the firms we have visited, we found that there was a fragmentation of CASS operational oversight, with responsibility for CASS being split between a number of staff across the compliance, operations, finance and/or corporate treasury functions. This often results in poor senior management oversight and a poor control environment that increases the likelihood of non-compliance and client detriment.¹⁰⁰⁴

555. The ability to establish clear individual responsibility is an essential pre-cursor to effective enforcement, a matter considered further in Chapter 10. Martin Wheatley said :

you have to be able to show the clear evidential trail from a senior figure, a particular abusive decision, to what actually happened. There may be some—I am not saying that will not be any—but in many large organisations it is very hard to provide that evidential trail.¹⁰⁰⁵

556. The primary purpose of the significant influence functions within the Approved Persons Regime as currently designed is not to assign responsibilities, but rather to verify whether individuals are fit and proper to take up fairly broadly-defined roles. To some extent this may be appropriate, since it should not be for the regulator to specify how a firm should organise itself and divide responsibilities. However, it means that the

1001Ev 745

1002Q 2992

1003Ev 745

1004FSA, Policy Statement 10/16, *Client Assets Sourcebook (Enhancements) Instrument 2010*, October 2010, p 34

1005Q 4496

Approved Persons Regime is not currently a mechanism for instilling a sense of personal responsibility among senior bank staff. Nor can it be used as the basis for identifying who is responsible for key activities, and for requiring them to take corrective action or holding them to account when things go wrong.

A one-shot approach

557. The focus of the Approved Persons Regime at present is very much at the “approval” stage. Individuals must remain fit and proper while they are in post, but the FSA explained how it is harder to remove someone’s authorisation than to deny it in the first place:

in circumstances where we view that an individual is no longer fit and proper under the current regime, this requires us to take formal enforcement action unless the firm and individual willingly cooperate in withdrawing the approval. The burden of proof to evidence that an individual is no longer appropriate to be an approved person is with the regulator once the individual is approved and involves us evidencing someone is no longer fit and proper. This is in contrast to decisions prior to approval where the burden of proof for a particular individual’s fitness to take on a particular function rests with the applicant firm and individual.¹⁰⁰⁶

558. Individuals have to seek new approval if they take up a new controlled function, but not if the nature of their existing function changes. For example, if an individual were approved to be a manager of a particular division which then grew significantly in size, there would be no opportunity to formally re-assess whether they were suited to handling the associated responsibilities.¹⁰⁰⁷ Similarly, if the regulator had some concerns about an individual being put forward for approval, for example about their competence, it would either have to turn them down completely or approve them. When approving someone, the regulator could set out its concerns and suggest a learning and development plan, but would lack formal powers to follow up on whether the concerns were subsequently addressed.

Bureaucratic complexity and inertia

559. The Approved Persons Regime has been amended various times since its creation, but it has grown into a complex and unwieldy tool which further incremental changes alone seem unable to reform. The FSA had intended to introduce new SIFs relating to more specific positions following the Walker Review of Corporate Governance in late 2009, having concluded that the then existing structure of SIF roles did not contain sufficient segregation of key roles within bank governance structures.¹⁰⁰⁸ A consultation paper issued by the FSA in January 2010 identified nine possible new SIF roles such as chairman, chairman of specific board committees, and executives in charge of finance, risk and internal audit.¹⁰⁰⁹ The policy commitment to place these new roles within the Approved

1006Ev 746

1007Ev 793

1008FSA, Consultation paper 10/3, *Effective Corporate Governance*, January 2010, p 9

1009 *Ibid.*

Persons Regime was confirmed in a policy statement issued by the FSA in September 2010, which included a timetable for implementation by firms, largely by July 2011.¹⁰¹⁰

560. However, in March 2011, the FSA issued a press releasing stating:

There is a considerable programme of work underway on ONA [Online Notifications and Applications] and we have been unable to complete the necessary changes to allow us to accept these applications and notifications [...]. So we are deferring the implementation of these changes to the Approved Persons Regime until further notice.¹⁰¹¹

In October 2012, the FSA confirmed that a separate proposal to add another, non-SIF, role was also being delayed for an unspecified period due to the higher priority attached to “an essential Information Systems programme of work”.¹⁰¹²

561. The Approved Persons Regime is operated via an online notifications and applications platform (ONA).¹⁰¹³ There has been some industry criticism about the effectiveness and adaptability of ONA, in response to which the FSA has stated “The complex changes around the reform of the UK regulatory structure have had an impact on our regulatory system, including the online notification and applications system”.¹⁰¹⁴ It is perhaps notable that the application process for the new controlled functions CF10a (introduced in October 2011) and CF40 and CF50 (introduced in April 2013) are paper-based rather than using ONA.¹⁰¹⁵

562. In April 2013, the FCA provided further information on progress on the reform ideas that first emerged in January 2010. It stated that, while these changes had “had to be deferred for operational reasons [...] we are now considering these plans in the light of the new regulatory framework”. After outlining possible further reforms relating to the identification of key roles, the FCA stated that “All proposals will be consulted on as necessary, in due course”.¹⁰¹⁶

563. The Approved Persons Regime was established in the Financial Services and Markets Act in 2000 under the sole control of the FSA. The regime has not been changed significantly following the division of the FSA into the FCA and the PRA under the Financial Services Act 2012, but new arrangements have been put in place to address the fact that both regulators have an interest in the people who run banks. The Act requires the regulators to specify functions in a way which minimises the likelihood of a person requiring approval from both bodies. This has resulted in a complex division of responsibilities:

1010 FSA policy statement 10/15 *Effective Corporate Governance*, September 2010, pA5: 2

1011 FSA Press Release 25 March 2011

1012 FSA consultation paper 12/26 *Regulatory Reform: the PRA and FCA regimes for Approved Persons*, October 2012, p 14

1013 FSA, *Online notifications and applications (ONA)* www.fsa.gov.uk

1014 “FSA—we regret mortgage registration delays”, *Financial Times Advisor*, 26 February 2013, www.ftadvisor.com

1015 FCA, *Approved persons and appointed representatives*, www.fca.org.uk

1016 Ev 795

- The PRA will authorise people for roles CF1, CF2, CF3, CF4, CF5 CF6 or CF28 in relation to banks;
- The FCA will authorise people other than these in relation to other controlled functions;
- Where a PRA-authorised person also performs a CF8 function, which would normally fall under the FCA, they do not need to make a separate application to the FCA but must notify them of when they begin or cease to perform the role; and
- Where a PRA-authorised person also performs functions other than CF8 which fall under the FCA, they must seek separate authorisation from the FCA.¹⁰¹⁷

Conclusions: the failure of the Approved Persons Regime

564. 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.

565. The PRA has announced that it intends to undertake a fundamental review of the Approved Persons Regime in order to ensure that it is fully aligned with, and effective in delivering, the PRA's statutory objectives.¹⁰¹⁸ The FCA has entered "the first (pilot) stage" of a review of Significant Influence Functions involving a sample of 8 firms, and intends "the results of this pilot review" to serve as the basis "to consider our approach to a full review".¹⁰¹⁹ 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.

1017PRA and FCA Handbook SUP 10A, 10B, www.fshandbook.info; PRA, *Approved Persons- FAQ*, www.bankofengland.co.uk/pr

1018FSA, Consultation paper 12/26 *Regulatory Reform: the PRA and FCA regimes for Approved Persons*, October 2012, p13

1019Ev 1527

566. 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.

The role of professional bodies

Is banking a profession?

567. In view of the ineffectiveness of the Approved Persons Regime as a control on the standards of individuals within banks, the Commission considered evidence on the role that professional bodies might play in taking up the slack. The Chartered Insurance Institute suggested that professions generally embodied “the so-called three pillars of professional standards”, which it listed as:

Qualifications: Qualifications to provide practitioners with an appropriate level of knowledge and understanding. This acts as a signal of quality to consumers as well as ensuring expertise.

Continuing professional development (CPD): Undertaking continuous learning helps practitioners keep their knowledge and understanding up to date which is essential in an industry that changes rapidly.

Ethics and integrity: A commitment to act in the interests of consumers is crucial to ensuring honest selling practices and good conduct.¹⁰²⁰

To these three pillars might be added a fourth pillar in the form of “professional standards bodies”—organisations which provide qualifications and training, set out the expected code of conduct and police behaviour.

568. Some witnesses suggested that banking exhibited characteristics that would make it a profession, even if, at the moment, all of the necessary components of a profession did not exist.¹⁰²¹ The Chartered Banker Institute said:

Banking is a profession: many interactions between banker and customer are characterized by an asymmetry of information in the bankers' favour, bankers require specialized professional knowledge and skills, and there is a clear public interest in the successful and sustainable operation of the banking system.¹⁰²²

The Chartered Insurance Institute agreed that information asymmetries inherent in financial services are the reason why professional standards are a crucial ingredient.¹⁰²³ The Chartered Institute for Securities and Investment said:

1020Ev 947

1021Q1845; Ev 1109

1022Ev 926

1023Ev 947

banking has to decide whether it is a profession or a trade. If it believes it is a profession, then it has to behave like one and accept or adopt the generally recognised requirements of a profession.

569. However, Neil Jeffares, a former senior City banker, warned:

Banking is a strictly profit-making business, and is not, and never has been, a profession in the sense that, say, medicine or the law is. Many in the City, including myself, have been confused about this, and have attached undue attention to the protection of reputation and sought to impose what we saw as professional standards on staff in the mistaken belief that such values would attract business.

He went on to point out that the crucial difference in banking is that customers are rarely buying the knowledge and services of an individual, but instead are transacting with a corporate entity:

There may be tiny parts of the industry which could be set up as professional activities, for example M&A advice, but these are activities which involve the sale of labour alone and cannot generate the level of income required to be part of a large banking business.¹⁰²⁴

Qualifications and training

570. Many professions require a common qualification or set of qualifications which all practitioners must hold. This may involve a common degree, such as in law or medicine, or qualifications undertaken as part of entry to the profession such as in accountancy or teaching.

571. A number of witnesses noted that there had been a decline in the level of professional qualifications held by those working in banking. The IFS School of Finance (formerly the Chartered Institute of Bankers) observed:

Until the end of the 1980s there was an important understanding that if somebody was serious about a career in a bank, he/she would have to ‘do their banking exams’. [...] Take up of traditional banking qualifications has slumped in the last 20+ years. There is no longer even an expectation that anybody wishing to aspire to top office in a bank should have a “banking” qualification. Witness the number of senior executives in the industry that have a range of qualifications, but not one specifically in “banking”.¹⁰²⁵

Simon Thompson, Chief Executive of the Chartered Banker Institute, thought that there had been “a professional culture in banking, probably until the late 1980s”.¹⁰²⁶ His organisation provided figures charting the decline in its own membership and that of another Chartered Institute:

1024Ev 1168

1025Ev 1126

1026Q 2403

In the 1980s, there were as many as 150,000 members of what was then the Chartered Institute of Bankers (CIB), and approximately 10,000 members of the Chartered Institute of Bankers in Scotland (CIOBS). CIB membership had fallen to no more than 22,000 by 2010, with CIOBS/Institute membership remaining relatively constant at 10,500. It is clear, however, that of the approximately 450,000 individuals employed in UK banking today, only a small proportion are professionally qualified in banking and members of a recognized professional body for bankers. In particular, only a small proportion of senior bankers are members of a recognized professional body for bankers.¹⁰²⁷

572. Professional qualifications have never been a formal requirement for being a “banker”. Some specific functions within banking already entail specific professional requirements. For example, lawyers, accountants and actuaries operating in that capacity within banks are likely to be subject to the requirements and disciplines of their own professions. The FSA’s recent Retail Distribution Review required retail investment advisors, some of whom will be found within banks, to meet professional requirements including qualifications and membership of an accredited body.¹⁰²⁸

573. Some witnesses proposed that entry qualifications and continuing professional development should be extended and made mandatory across a wider range of individuals working within banking. The TUC argued for the “introduction of appropriate entry requirements and ongoing professional licensing”,¹⁰²⁹ while Peter Vicary-Smith said that “you would expect them at least to have some form of qualification and training in things such as how to serve a customer and what is fair treatment”.¹⁰³⁰

574. Accord made a case that was more focused on the higher echelons of retail banks, proposing that “acquisition of appropriate banking qualifications” should be:

a necessary and minimum requirement for those holding senior management positions in UK retail banking institutions. Like many others, Accord members were shocked when the Chairmen and Chief Executives of RBS and HBOS revealed to the House of Commons Treasury Committee in February 2009 that they did not possess a banking qualification between them.¹⁰³¹

Such an approach focused only on senior individuals would contrast with the legal profession where controls are at entry level and, following recent reforms, it is possible to own and manage a law firm without being a qualified lawyer.¹⁰³²

575. The IFS School of Finance argued that a single compulsory qualification for bankers would not be appropriate:

1027Ev 926

1028FSA consultation paper 10/14, *Delivering the RDR*, June 2010, p 9

1029Ev 1367

1030AQ 25

1031Ev 736

1032Legal Services Act 2007, Part 5

the term ‘banker’ could be used to describe a range of individuals in a bank performing a very wide variety of different roles having achieved professional qualifications from a variety of professional bodies. The concept of a one-size-fits-all professional qualification for “bankers” is outmoded, unrealistic and probably inappropriate.

[...] we have always avoided making any call for a one-size-fits-all mandatory professional qualification or for compulsory membership of a professional body. These calls belie the complexity of the industry. They are an over simplification believing that there are easy tabloid-headline grabbing solutions.¹⁰³³

Barclays agreed that “a single specific technical banking qualification” was inappropriate in view of the diversity of banking, but contended that there was a shared core of knowledge:

There are clearly [...] some foundations of financial knowledge which underpin all aspects of banking—retail and wholesale—alongside the need to be properly skilled to undertake each specific role.¹⁰³⁴

576. Some banks stated that they had started placing a greater emphasis on formal qualifications. RBS referred to their programmes for relationship managers and retail bankers, which are externally accredited.¹⁰³⁵ Lloyds Banking Group commented on the accredited training they make available to staff.¹⁰³⁶ Benny Higgins, Chief Executive of Tesco Bank, stated that his organisation’s aim was for “every one of our front-line colleagues to have a professional qualification related to the work they do”.¹⁰³⁷ The IFS School of Finance said that “some of the large high-street banking firms in the UK have started to put their staff through qualifications”, with its qualifications for front-line bank staff having been taken by over 5,000 bank staff, a number that was expected to more than double over the following 12 months.¹⁰³⁸ The Chartered Banker Institute said that 17,000 individuals held one of their professional banking qualifications, and that over the previous three years a further 17,000 individuals had completed a third-party course accredited by the Institute.¹⁰³⁹ Santander argued for giving more weight to the qualifications provided by existing professional standards bodies:

We believe that the Chartered Institute of Bankers in Scotland (CIOBS) and the IFS are suitable organisations to work with on the introduction of such industry-wide qualification regimes. We would support moves to extend the reach of these organisations and put their work on a more formal footing.¹⁰⁴⁰

1033Ev 926

1034Ev 798

1035Ev 1324; AQ327

1036Ev 1218

1037AQ 97

1038Ev 1126

1039Ev 926

1040Ev 1326

Standard setting and codes of conduct

577. A second important component of a profession emphasised by witnesses was that there should be a common code of conduct, with a high level of understanding among practitioners about the expected standard of behaviour. Such a code would be embedded in training. Barclays argued for “an industry-wide ‘code’ of professional standards”.¹⁰⁴¹ CFA UK said “All staff should be required to abide by and adhere to a code of ethics and standards of professional conduct”.¹⁰⁴² Which? stated:

There is an urgent need for a redefinition of acceptable practice in banking that we believe should be based on a new Good Financial Practice Code. This code should have similar status amongst the banking profession as codes of conduct have in the medical and other professions.¹⁰⁴³

The CBI suggested:

A single standard of baseline ethics is required across the entire industry, which firms can then use as a minimum standard on which they can base their own individual, firm-level codes of conduct.¹⁰⁴⁴

578. Some witnesses warned not to put too much faith in codes. Gavin Shreeve, Principal of the IFS School of Finance, said:

if the culture of an organisation is not driven from the top—I am not just talking about the senior executives here, I am talking about boards, shareholders and the whole culture of expectation around behaviour—as to what is permissible or not, then all the codes in the world will not make a jot of difference to that.¹⁰⁴⁵

The IFS School of Finance pointed out that the banking sector has not lacked codes in the past:

When it comes to ‘codes’ for governing behaviour or standards for skills and competencies or a range of qualifications to educate practitioners, few sectors in the economy could better the banking sector where the list is almost endless. Yet despite this plethora of ‘codes’ and ‘standards’, including those already supposedly enforced by the regulator, public trust in banking is at rock bottom. Another list of ‘standards’ or yet another ‘code’ will not make any discernible difference to public perception that the industry is simply not capable of self-regulation.¹⁰⁴⁶

579. Which? pointed out that the Goldman Sachs code of business conduct and ethics in 2009 championed “integrity and honesty” as being “at the heart of our business”, but contained a caveat that “from time to time, the firm may waive certain provisions of this

1041Ev 798

1042Ev 919

1043Ev 1443

1044Ev 913

1045Q 2418

1046Ev 1126

Code”.¹⁰⁴⁷ Another example of a code is the Worshipful Company of International Bankers’ Principles of Good Business Conduct, which set out high level statements about honesty and integrity and were suggested by the BBA as a possible model for a new cross-industry code.¹⁰⁴⁸ However, it is perhaps telling that in the WCIB’s evidence the only reference they make to how the principles are currently promulgated is that “Members of the WCIB (and their guests) are reminded of the Principles at each annual banquet as they are reproduced in full on the menu card for the event”.¹⁰⁴⁹

580. Several banks referred to the Chartered Banker Professional Standards Board (CB:PSB), which is a voluntary initiative launched in 2011 and supported by nine leading banks. The Chartered Banker Institute stated that the CB:PSB’s aim is:

to promote a culture of professionalism amongst individual bankers, by developing and implementing industry-wide professional standards which enshrine the very best ethical, professional and behavioural qualities.¹⁰⁵⁰

The CB:PSB has issued a code of conduct which sets out “ethical and professional attitudes and behaviours expected of bankers”, which CEOs of all member banks have agreed to subscribe to and are implementing within their organisations.¹⁰⁵¹ It is also developing a series of professional standards aimed at bankers with different levels of expertise and specialism, which will “set clear benchmarks against which colleagues, customers and others can measure bankers’ professional competence”.¹⁰⁵²

581. An effective code for standards of professional behaviour cannot be a document which employees simply sign and then forget about. The expected standards must be embedded in an individual’s objectives, training and appraisal. Gavin Shreeve explained the role that training bodies can play in imbuing all their students with an understanding of acceptable banking behaviours:

our qualifications are structured in such a way—in common with many universities—whereby in level 4, your first year, there is a commonality before you go off and specialise. [...] Imbued in all of that is also behaviour management—what is acceptable behaviour—and the management structures. There is a core that everybody does regardless of whether or not they specialise.¹⁰⁵³

However, in the absence of true professional requirements in banking, it is questionable to what extent existing bodies focus on behaviour as opposed to the technical skills likely to be more prized by employers. A review of the syllabus for the IFS professional certificate in banking suggests that standards feature less prominently than Mr Shreeve’s statement

1047Ev 1443

1048Ev 1470, 857

1049Ev 1470

1050Ev 926

1051*ibid.*

1052Chartered Banker Professional Standards Board, *Framework for Professional Standards*, www.cbpsb.org, October 2011, p 2

1053Q 2249

would imply. For example, the detailed syllabus of the module on business lending makes no reference to culture, standards or the need to treat customers fairly.¹⁰⁵⁴

Discipline and control

582. In some established professions, professional bodies have an important and sometimes leading role in the exercise of control on individuals within the profession. Standards based on the code of conduct and the required qualifications are set and given force by the fact that breaches can result in disciplinary action, up to and including exclusion from the profession. Some witnesses proposed that a professional standards body should be given a comparable role in enforcement in banking. Mike Dailly, from the FSA Consumer Panel, believed that such a body would overcome the problems the FSA faced in enforcement because “having a profession [...] gets round all the legal problems about criminal sanctions and civil sanctions.”¹⁰⁵⁵ The Church of Scotland also advocated giving a professional body for banking enforcement powers,¹⁰⁵⁶ as did the consumer group Which?:

There is an urgent need for a redefinition of acceptable practice in banking that we believe should be based on a new Good Financial Practice Code. This Code should have similar status amongst the banking profession as codes of conduct have in the medical and other professions. This Code should be devised and enforced by a new professional standards body along the lines of the General Medical Council or the Legal Services Board.¹⁰⁵⁷

583. The BBA made the case for the establishment of a Banking Standards Review Council (BSRC), which it argued would need “some statutory or regulatory support” in order to be “credible and effective”, but was cautious on whether this would constitute a disciplinary body.¹⁰⁵⁸ It noted that the BSRC would “need to have some statutory or regulatory support, be independent of the industry and be universally applicable to all sectors of the banking industry”.¹⁰⁵⁹ However, it acknowledged it to be “difficult to see how the Banking Standards Review Council could have a role in individual cases of misconduct without duplicating the existing Approved Persons Regime and encountering difficulties with employment law and Human Rights legislation”.¹⁰⁶⁰

584. Barclays thought that some of these difficulties could be overcome. It made the case for a professional standards body with disciplinary powers, arguing that a BSRC could establish a code and then “enforce requirements for sanctions against breaches of the code”. It acknowledged that:

To be effective, [...] individual covered firms would need to commit (or be compelled by statute) to communicate to the BSRC where a colleague is dismissed for a serious

1054 www.ifsllearning.ac.uk/qualifications

1055 AQ 20

1056 Ev 962

1057 Ev 887

1058 Ev 852

1059 *ibid.*

1060 *ibid.*

breach of the standards set out in the ‘code’. Those firms would also commit to checking with the BSRC before they hire any individual.¹⁰⁶¹

Sir David Walker explained how this approach could provide more effective enforcement than a regulator:

the core proposition [...] is to have a concept that everyone working in banking is, to an appropriate degree, part of a professional body. This would be alongside, but much bigger than the Approved Persons regime.

[...] The disciplinary process that I would have in mind and would commend is that those banks—let’s take Barclays—that participate, and I imagine that most banks would wish to participate in such an arrangement if it were set up, would undertake that when someone is fired or separated because they do not conform to the standards, we would have an obligation to indicate to the register, or whatever it is called, that that individual had left our employment because of a breach. It would still be open to that individual to appeal and say to us, “I have been dismissed unfairly”, and employment law would persist.

It is very important that we not only are able, but have an obligation to put on the register that the individual has been separated for a particular reason. The counterpart of that is that there would be an obligation on any bank that wished to employ that individual to consult the register and take a view about whether they wanted to employ the individual—he or she having a mark against them.

RBS also supported the proposal for a professional standards body having disciplinary powers, referring to the Chartered Banker Professional Standards Board (CB: PSB) established under the Chartered Banker Institute:

We would also support giving the CB: PSB powers to maintain a register of accredited bankers and to strike off those who fall short of the required standards [...] Provided the standards expected are reasonable, the consequences of breaching those standards clear, and the processes of investigation, judgment and appeal fair, we do not believe that organisations or individuals should fear this approach.¹⁰⁶²

585. In contrast, the City of London acknowledged that no answer had yet been found to the question of how far and in what form a new body should undertake enforcement:

Whether a Banking Standards Council would have supervisory, enforcement and disciplinary responsibilities, or any other powers in relation to the regulatory regime, is a matter still to be resolved [...] One issue which remains unresolved at the moment is the need, if any, for the proposed Banking Standards Council to hold a separate Register, and how that would link with those individuals on the Approved Persons Regime, a Regime which should continue.¹⁰⁶³

1061Ev 809

1062Ev 1321

1063Ev 973

586. It is notable that the existing professional standards bodies in banking have to date failed to make use even of what limited enforcement action is already within their powers—removal of membership. The President of the Chartered Banker Institute confirmed that Fred Goodwin was still a member of the Institute, even though this was “a matter of very considerable concern to the great majority of our members”, as well as being “a legitimate matter of public interest”. He explained that Fred Goodwin had “not been judged to have breached the FSA’s Principles for Approved Persons, to which the Institute’s Code of Conduct has been mapped”, and thus could not be judged to have breached that Code of Conduct without a separate investigation. The Institute had no statutory powers of investigation, and no power to ensure a fair hearing for a member subject to disciplinary proceedings.¹⁰⁶⁴ Fred Goodwin had his knighthood removed without any judicial process, and it was reported that even a golf club had taken a decision to refuse him membership, but the relevant professional body felt constrained from acting.¹⁰⁶⁵ This is despite the fact that membership of the Chartered Banker Institute has little or no effect on an individual’s ability to act as a banker.

Lessons from other sectors

587. In order to consider what role a professional standards body could play in providing an individual enforcement regime, we looked at how such bodies operate in other sectors, in particular in the professions of law, medicine and accounting. Representatives from the relevant bodies argued that they had credible and effective sanctioning regimes, with a range of sanctions very similar to those available to the FSA. Vernon Soare, Executive Director of the Institute of Chartered Accountants in England and Wales, said:

We can give various levels of reprimand. We can give a consent order, which is a fine and an admission of wrongdoing. Those are published. If it is a serious matter, a consent order is probably not appropriate, so it goes through to our full disciplinary committee, a tribunal of which will hear the case in public. The outcome can be unlimited fines with exclusion from membership for a period.

[...]If we have licensed somebody for audit—in the parlance, a “responsible individual” who is licensed to sign off on company audits—our sanctions go right up to taking away the licence from the individual and de-registering the firm, but there are various conditions we can place on their licence and fines as well. There is quite a range of penalties that we can introduce.

588. Professor Sir Peter Rubin, Chairman of the General Medical Council, told us:

We have a range of powers, which include the power to stop a doctor practising immediately if there is a prima facie case while we are waiting for the case to be heard. Then we have got powers to give letters of advice, letters of warning, conditions on practice and either to suspend from the medical register or to erase from the register. [...] Under the Human Rights Act there has always got to be the right of appeal at some point down the line.

1064Ev 1517

1065“Sir Fred Goodwin’s application to join R&A Golf Club in shreds”, *The Telegraph*, 9 May 2009, www.telegraph.co.uk

Every year, under 100 doctors would be erased from the register, but a good deal more than that [...] would have conditions put on their practice or have letters of warning. All those sanctions, down to and including letters of warning, are on our website. They are public. Anybody can get into our register and see whether a doctor has had a letter of warning and why they had that letter of warning, or see whether they have been erased from the register. When we do that, we also let every medical regulator in the world know, on a monthly basis, that we have taken action against that doctor.¹⁰⁶⁶

Antony Townsend estimated that between 50 and 100 solicitors were struck off each year, with around 200 to 300 cases going to tribunal, adding that “quite a lot of sanctions in the lower category do not get as far as the tribunal”.¹⁰⁶⁷

589. In some established professions there is normally a clear distinction between functions such as professional development and the mechanism for investigating breaches and imposing sanctions, with the latter being on a statutory basis. Dr Timothy Johnson of Heriot-Watt University noted that:

Most professions have a professional body running in tandem with the statutory structures. There is the Legal Services Board and the Law Society, the General Medical Council and the medical Royal Colleges, the Financial Reporting Council and the actuarial, accounting and auditing professions. This distinction has emerged following, for example, the Clementi Legal Services Review and the Morris Review of Actuarial Standards. The bodies established in the Financial Services Bill [the FCA and PRA] correspond to bodies under the Legal Services Board and the Financial Reporting Council; the complementary professional bodies do not exist.¹⁰⁶⁸

The key reason for such separation is that, if a professional standards body is to be able to impose meaningful sanctions such as removal of livelihood or fines, under Article 6 of the European Convention on Human Rights (ECHR), individuals have a right “to a fair [...] hearing by an independent and impartial tribunal”.

590. As some witnesses noted, other professions have had to reform their structures and enforcement mechanisms in response to scandals, in order to restore or maintain trust. Sir Peter Rubin of the General Medical Council stated:

I think that professional self-regulation in a number of professions has failed over many years—and sometimes failed spectacularly. In my own profession, for example, the Bristol heart surgery scandal was the defining moment when it was clear that professional self-regulation was not working.¹⁰⁶⁹

Vernon Soare of the Institute of Chartered Accountants in England and Wales added:

1066Q 1823

1067Q 1817

1068Ev 1172

1069Q 1784

Our equivalent of the Bristol incident was perhaps Enron, and subsequent to Enron, the powers and responsibilities of the Financial Reporting Council were widened.¹⁰⁷⁰

591. In order to ensure that the procedures for imposing sanctions are robust and effective, reform in other professions has increasingly meant giving a statutory basis to disciplinary powers. Professor Sir Peter Rubin told us: “There is still a role for professional self-regulation within teams and organisations but, in my view, and certainly as far as my profession is concerned, there has to be a statutory backstop that can oversee the whole process”.¹⁰⁷¹ Vernon Soare explained how, in the accountancy profession, bodies such as the Institute of Chartered Accountants in England and Wales have taken over many of the statutory individual enforcement responsibilities from the FRC:

There has to be a relationship and our example of how the accountancy profession is regulated is a way it could be done [...] we are overseen by the Financial Reporting Council as to how we carry out our statutory responsibilities. In that sense, we, as the profession, regulate our members and firms, and, in turn, we are overseen by the Financial Reporting Council, which publishes Secretary of State reports.¹⁰⁷²

Making a choice

592. The Commission received strong encouragement to put a great many eggs in the professional standards basket. The Chancellor stated:

I hope this Commission would look at other issues, like the standards we expect of the profession—for example, in the medical profession or the teaching profession we expect certain standards and those standards are often administered by the profession, so how can we create something similar in the banking industry?¹⁰⁷³

After the Commission concluded taking oral evidence, Anthony Browne expressed confidence that we would make proposals in this area:

The British Bankers’ Association has made proposals for a banking standards review council to set, monitor and uphold professional and ethical standards and the Parliamentary Commission on Banking Standards is also set to push in this direction.¹⁰⁷⁴

593. In a number of established professions, the disciplinary framework for individuals has developed organically over a long period, alongside a professional ethos, professional standards, and the associated knowledge, learning and behaviour. Some of the evidence received by the Commission envisaged the fast-track creation of a professional body for banking which would establish a new disciplinary framework while simultaneously raising the level of professional standards and associated knowledge.

1070Q 1786

1071Q 1784

1072Q 1796

1073Q 1026

1074“Banks must show they are now very different creatures”, *City A.M.*, 19 April 2013, www.cityam.com

594. Martin Taylor was very sceptical about the timetable over which a professional standards body could add value in banking:

Simply introducing a code of conduct and making everybody sign it would be the wrong way round. Doing that would be to start at the end. If the industry or a single institution decided what professional standards really ought to be and worked with its staff to get towards that, at the end you can have a proper professional body, but you do not make a medical profession by calling all the quacks ‘doctors’, if you see what I mean. You have to go through the proper process.¹⁰⁷⁵

Malcolm Crow, a long-standing employee of a Swedish bank, identified the risks associated with concentrating on creating a new professional code and body for bankers:

Any high level mandated code of conduct faces the choice between being universally applicable or honed to deal with particular parts of the banking industry. In the first instance, it is likely to be based on universally acceptable broad standards, which are unlikely to add greatly to the FCA’s Principles. In the latter instance, it will require a great deal of work to target the code to particular business areas – resulting in a plethora of sub-codes and training requirements, adding complexity and cost without actually bringing any real additional benefit. There is a great risk, therefore, that any British Banking Standards Board (call it what you will) will merely be a costly sinecure without producing any tangible additional benefit, other than appeasing the demand for action.¹⁰⁷⁶

595. The Institute of Chartered Accountants in England and Wales considered that, while a professional standards body could play a useful role in some areas, enforcement would need to remain the responsibility of the regulators for the foreseeable future:

The Commission should challenge the banking sector to develop an effective model of professional standards that supports and encourages personal and organisational integrity, is underpinned by effective monitoring and enforcement mechanisms and that can be seen to promote confidence. A sound and effective regulatory system will always be required, and should complement such a model. If the banks took professional standards seriously (and could demonstrate that they did), government or independent regulation might become closer to a backstop, rather than a primary means of maintaining confidence in the financial system. However, it may take a generation to achieve this objective of having professional standards in banking that inspire confidence.¹⁰⁷⁷

The FSA emphasised the risks associated with placing formal responsibilities on a professional standards body:

Any proposal to establish a new professional body with mandatory membership which was separate from the existing regulator(s) could therefore duplicate and overlap with [...] existing powers. Alternatively it could take over the role of

1075Q 416

1076Ev 1520

1077FR Ev 68

regulation of individuals from the FSA/FCA/PRA. The first of these outcomes could lead to confusion of responsibilities and an increase in regulatory costs, while the second would lose the benefits arising from regulators which can look at the conduct of both firms and the individuals working within them on a unified basis.¹⁰⁷⁸

Simon Thompson, the Chief Executive of the Chartered Banker Institute, echoed the view that a choice had to be made:

We would like to see a single register for bankers. I think one of the issues is individuals being members of one of many professional bodies. I think a single registration body that holds a single register that customers could check and make a complaint against would be very helpful. Clearly we would want to see proper mechanisms for bankers to be struck off that register if they misbehave. How that is done—I think there are two models. You could either look to have an extended FSA register or you could have a new independent register of banking professionals.¹⁰⁷⁹

596. 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.

597. 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.

598. 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

Our approach

599. 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

¹⁰⁷⁸Ev 1483

¹⁰⁷⁹Q 2427

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.

Codes of conduct and enforcement

600. 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.

601. 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.

Participation by banks

602. In his evidence, Sir David Walker, a prominent advocate of a unified professional body for banking with a wide-ranging role, indicated that he viewed participation by banks in such a body as voluntary, referring to his belief that banks would wish to participate in such a body.¹⁰⁸⁰ **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.**

Scope

603. In describing their commitment to extend professional qualifications within banking, both individual banks and current providers of training referred variously to “front-line” staff, retail banking, “high-street banking” and “relationship managers”.¹⁰⁸¹ This approach suggests a risk that an approach will develop which concentrates on staff at lower levels or who have customer-facing roles, excluding staff involved in other crucial activities within retail banking and in wholesale market activities.

604. Just as there is a risk that a professional body might concentrate on the retail rather than wholesale banking, there is a risk that it will focus on new entrants at the most junior levels of the industry. Imposing a requirement for a mandatory qualification for all those operating within the industry without regard to past experience would impose an unfair burden upon many individuals at all levels. However, an arrangement whereby those of a certain seniority or experience were deemed exempt from any professional requirements would pay scant regard to one of the lessons of recent events. In our Fourth Report on the failure of HBOS we observed that:

The executive leadership represented on the Board came predominantly from a retail and insurance background. [...] There was insufficient banking expertise among HBOS’s top management. In consequence, they were incapable of even understanding the risks that some elements of the business were running, let alone managing them.¹⁰⁸²

605. It is possible that, as a result of career paths that bypass commercial banking, fewer individuals rising to senior levels in recent times have had substantial direct experience of credit assessment and what causes loans to go bad. This may even be true for those who do have a background in commercial banking, as a result of increased reliance on automatic credit scoring and the creation of specialised debt recovery units. Whereas in the past senior executives would have had this essential grounding without the need for training or qualifications, there may be a greater need now to ensure that people running a bank have the right knowledge to avoid future crises. The fact that individuals can run banks and take decisions involving significant prudential risks without being required to have any formal qualification or background in the field is a particularly notable gap.

606. The main challenge in establishing a common set of standards and requirements for banking is that this is an industry which carries out a diverse and rapidly evolving set of activities. In professions such as medicine, law and accountancy there is a large common core of skills and values inculcated in the course of pre-qualification education or training. Banking is not currently a profession in the same way and cannot become so by the stroke of a pen. The wide variety of roles in banking, and the focus on commercial transactions rather than individually-provided services, represent significant barriers to a process of professionalisation.

¹⁰⁸¹See for example, Ev 803, 806, 1127, AQ 13

¹⁰⁸²Fourth Report, para 93

607. The starting point for the successful development of a unified professional body for banking must be a commitment to identify the core common skills required of those working in banking, with particular emphasis on the skill set required of those at the very top of banks. At the same time, it must address the challenge that there is likely to be no one-size-fits-all solution to an industry as diverse as banking. It will only establish and maintain its credibility if it establishes qualifications or professional requirements which are relevant at various levels and in various forms of banking. A set of expected qualifications which forces bank clerks to night school for years to come, but gives a free pass to those working in wholesale banking or at more senior levels—the groups which most conspicuously failed in recent years—would ignore the lessons of the crisis.

Training and continuing professional development

608. The professional bodies already operating within banking have forged their reputation on their role in providing the training necessary to secure professional qualifications. Indeed, one of those bodies, now renamed the IFS School of Finance, has effectively transformed itself into a training provider. A unified professional body might play a role, alongside other providers, in offering training and continuing professional development. However, we believe that a unified professional standards body should on no account be accorded a role as a monopoly supplier of certain training to the banking industry. A unified body's distinct contribution is more likely to be in helping to shape a curriculum for bank qualifications and for the accreditation of those qualifications.

Funding and independence

609. A key indicator of independence for professional bodies is whether, in addition to setting standards, they are also responsible for representing the interests of their members to government and in the media. The SRA and GMC were clear that they did not undertake such activities on behalf of their members. In the case of the medical profession a separate body, the British Medical Association, undertook such representative activities. While the Law Society represented the legal profession, there was a clear statutory division of responsibility for regulation to the SRA for solicitors and across the profession to the Legal Services Board. The ICAEW combined both functions, but defended the position as follows:

we have a representative function, but we also have statutory regulatory obligations under the Companies Act and so on. For us, the danger of the representative side influencing a regulation is uppermost in our mind. It comes down to good, strong governance procedures and the oversight provided by the Financial Reporting Council.¹⁰⁸³

610. The method by which a professional body is funded is also a factor which influences independence or at least the perception of whether or not a body is independent. All three professional bodies who gave evidence to us are funded mainly by membership fees but did not see this as an impediment to their independence. The GMC thought that funding

through a membership fee was a better system than other options, such as taxation.¹⁰⁸⁴ The SRA supported this view and emphasised the need for the board of a professional body to be independent of its members:

The best answer is to have a strong, independent regulatory board levying the profession. The dangerous position—this was the case going back 10 years in the law—is where the regulatory levy is over-influenced by a representative council that is looking to its members and is elected by its members. If you have a strong, independent regulatory board accounting for how it is spending its money, but levying its money in the public interest, that is the best way of getting robust, independent regulation.¹⁰⁸⁵

The BBA, in making the case for a new professional body in banking, acknowledged the need for the body to be independent both of the BBA and of individual banks.¹⁰⁸⁶

611. 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

Three new pillars

612. We concluded earlier that the slow and incremental approach to reform of the Approved Persons Regime envisaged by the FSA and the FCA, adding new functions in a piecemeal manner and as its inadequate operational systems permit, does not represent the right way forward. We have also concluded that a professional body for banking, welcome though its development would be, cannot fill the space currently occupied by the Approved Persons Regime and the associated enforcement arrangements. **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;**

1084Q 1798

1085Q 1807

1086Ev 852

- **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.**

A new regime

613. There is evidence to suggest that the Government and the regulators are already considering how to respond to acknowledged weaknesses of the Approved Persons Regime. In its consultation on sanctions for directors of failed banks, the Treasury stated that in order to address the lack of clarity about responsibilities and expected performance standards, it might be appropriate to introduce:

Clearer regulatory requirements regarding individual responsibilities and the standards required of people performing certain key roles; or

A firm-led approach, whereby the onus would be on the firm and individual to set out in detail in a written statement the responsibilities and duties of each role.¹⁰⁸⁷

Andrew Bailey noted:

It is important that senior figures [...] retain overall responsibility and accountability even where they have delegated responsibility for dealing with a particular matter to someone further down the management chain [...] It is worth examining how FSMA can be amended to ensure that enforcement action against individuals can be in respect of the reasonable responsibilities of their job, which they cannot delegate.¹⁰⁸⁸

614. Tracey McDermott acknowledged how the Approved Persons Regime provides an inadequate basis for enforcement against senior individuals, and told us the FCA are considering how to address this problem:

One of the problems we often find when we start enforcement action is that we start asking questions and people can't tell us who was in charge. One of the things we are piloting at the moment is doing what we are calling a SIF audit, where we are asking firms to tell us specifically who is responsible for particular major areas of their business.¹⁰⁸⁹

The FCA explained further the aims of this SIF audit:

The FCA is therefore planning to look, at least for the higher impact firms, at how it allocates responsibilities across its SIFs. This will encourage greater clarity within the firms themselves (to enable them to have better corporate governance and enhanced accountability), provide greater clarity of whom the regulators can look to address

¹⁰⁸⁷HM Treasury, *Sanctions for Directors of Failed Banks*, July 2012, para 3.17

¹⁰⁸⁸Ev 1499

¹⁰⁸⁹Q 2993

issues and to enable a more effective ongoing assessment of the fitness and propriety of SIF holders.¹⁰⁹⁰

615. Some witnesses put forward arguments for the importance of collective as opposed to individual responsibility, based on the view that this mitigates the risk of powerful individuals running their own fiefdoms without proper checks and balances. The Salz Review pointed out how this risk had materialised at Barclays in the run-up to the financial crisis, describing “a decentralised system of accountability with a powerful leader for each of the ‘clusters’”.¹⁰⁹¹ The Review noted how this led to less debate and challenge within the business:

Leaders of particular business units may be reluctant to challenge and debate the plans of other business units, to avoid provoking such challenge and debate in relation to their own.¹⁰⁹²

Stuart Gulliver said “I think that having joint and several responsibility—not ‘no one’s responsible’—is the way to manage the risk”, while Douglas Flint said this means that “you can’t sit in the room and say, ‘My gosh, so-and-so has got a difficult challenge, it’s his challenge not mine’”.¹⁰⁹³ However, moving too far towards a situation where everyone is responsible risks resulting in nobody being responsible.

616. 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.

Defining scope and responsibilities

617. 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

1090Ev 1474

1091Salz review: *An independent Review of Barclays’ Business Practices*, April 2013, para 9.48

1092*Ibid.*

1093Q 3784

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.

618. 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.

In Chapter 7 we make recommendations on some additional principles and some specific responsibilities which would need to be assigned.

619. Tracey McDermott told us that regulators already seek to identify a responsible individual when they impose remedial requirements on a firm:

when we ask somebody to undertake remedial work—often after a supervisory visit you will identify problems and you will say, ‘You need to go away and fix that’—we have said, ‘We need to know the name of the person who is responsible for fixing that.’ They give us the name of that person so that if it is not fixed we already start from the position that we know who is responsible.¹⁰⁹⁴

620. 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.

Entry, review and conditions

621. In recent years, the practice of interviewing those who are seeking to hold Significant Influence Functions has developed. Sir Mervyn King has already announced an intention to narrow the extent of such interviews, saying “we will reduce the number of people subject to the intensive regulatory interview process before appointment by limiting such interviews to the most senior people”.¹⁰⁹⁵

622. One weakness of the Approved Persons Regime is that ongoing review of fitness and properness for responsibilities has been hobbled by the weaknesses of the enforcement system and by the ‘all or nothing’ feel of refusal in the context of a regime which does little to distinguish between very different responsibilities. The FCA has suggested that a power to reassess individuals would be particularly useful in situations where the role performed by the person has changed sufficiently from the original position approved (such as where the bank has increased significantly in size and complexity or the scope of the role changing materially which may require different skills or skills at a different level).¹⁰⁹⁶

623. In the context of the current SIF approval process, the FSA argued that, in high-risk firms and for certain types of approval, the regulators should be able to limit approval to a certain time period.¹⁰⁹⁷ Sir Hector Sants made a similar and more specific proposal:

It would be helpful if authorisation of individuals could include conditions, albeit for a limited period of time. This would enable the regulator to formally identify actions which it requires members of management to carry out as a condition of maintaining their authorisation.¹⁰⁹⁸

624. The FSA opposed mandatory reassessment of SIFs, but suggested that:

it may be worth exploring the possibility of a more focussed and selective approach for certain categories of SIFs to either be reassessed in post or limiting their approval to a certain time period (in which case we may require them to reapply). This type of approach would likely only be applied to certain types of SIF approvals and limited to firms we consider present the greatest risks.¹⁰⁹⁹

625. 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

1095Speech by Sir Mervyn King to the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House, 15 June 2011

1096Ev 1527

1097Ev 1474

1098Ev 1333

1099Ev 1474

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.

626. 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.

627. 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

Broadening the regime

628. Our proposal for a Senior Persons regime addresses the weaknesses in personal responsibility at the most senior levels of banks. However, this represents only a partial solution to the much more pervasive failures of individual standards and culture in banking. Our proposals for a Licensing Regime seek to address these failures by tackling three wider issues: the patchy and inadequate coverage of the Approved Persons Regime, the need for banks themselves to be held responsible for promoting and upholding standards for their employees, and the need for a robust mechanism for sharing information about problematic individual behaviour.

629. The scandals relating to mis-selling and LIBOR illustrated the weaknesses of the Approved Persons Regime and the associated enforcement regime. Activities carrying important conduct risks were in the hands of people who were not required to follow the FSA's Statements of Principle for Approved Persons, and who the regulator was therefore constrained in its ability to sanction despite evidence of clear failures in banking standards.

630. The US regulatory authorities told us that their system utilised the concept of "institution-affiliated parties", which allows them to bring enforcement action against any employee of a bank from top to bottom.¹¹⁰⁰ The FCA called for

A power to take action against individuals that commit misconduct, yet fall outside of the Approved Persons regime. This would be accompanied by the application of a code of conduct to these individuals, so they would be clear what behaviour was and was not acceptable;¹¹⁰¹

631. The proposals for the Senior Persons Regime involve a targeted and specific approach for those in the positions at the highest levels and bearing the greatest responsibilities. Such a system would be unduly intrusive and burdensome if applied more generally. We asked Martin Wheatley whether coverage of the Approved Persons regime could be expanded without requiring a burdensome application and approval process. He replied:

Yes, I think we can. I think an application in advance to us for the number of people involved would be logistically difficult. So I think there is a way that people are deemed to be authorised by virtue of their employment.¹¹⁰²

632. 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.

633. 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

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1102Q 4502

likely to include all staff currently covered by the Approved Persons Regime, including those in customer dealing functions.

634. 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.

Making banks responsible

635. The evidence has led the Commission to conclude that in banking the gap is unduly wide between the role of banks in maintaining and upholding certain standards as employers of individuals, and the role of the regulator. Banking is an industry with a high turnover of staff, partly facilitated by the scale of remuneration pots available for redundancy and by the emphasis on time-specific bonuses, which weaken the loyalty of staff to a particular employer. This has weakened the incentives of banks to play their part in regulation of the industry, relying instead on the regulator.

636. Banks have always been corporately responsible for the behaviour of their staff, but it has been clear that they have not taken this duty sufficiently seriously. The Association of Financial Markets in Europe (AFME) wrote:

there are questions about the extent to which firms have sought to ensure that standards have been adequately embedded at all levels of the organisational hierarchy and the degree to which in practice, therefore, both individual and corporate standards act to assist firms in creating or maintaining a culture that fosters integrity [...] there may be questions about the extent to which governance standards at the group/firm level are sufficiently dovetailed with the standards that apply to individuals.¹¹⁰³

Several of the large banks stressed that they were already placing far greater emphasis on the professional standards and conduct of employees in their internal training, management and appraisal systems. However, as Martin Wheatley pointed out:

we are hearing a lot of good mood music at the moment, so we are hearing positive signs and very good speeches from CEOs of banks. They are all changing and talking about culture. The difficulty we face is whether we can trust that that will actually deliver an outcome, or whether it needs an additional push.¹¹⁰⁴

637. In established professions such as accountancy and law, firms themselves take on a major role in enforcing individual standards. While firms have primary responsibility for taking action against individuals who fail to uphold standards, where there are more serious breaches that merit a fine or prohibition from the industry such cases can be referred to the statutory regulator. The regulator is generally also able to pursue individual enforcement action regardless of whether a referral has taken place, if circumstances require. The Institute of Chartered Accountants in England and Wales explained the benefits of such an approach:

Self-regulation is often misunderstood and its importance under-estimated. We include among self-regulatory measures desirable features of any social group like integrity, self-discipline, adherence to norms of behaviour and peer-based enforcement of these norms. These features apply at both a personal and organisational level.

[...] Self-regulatory measures can help to encourage and reinforce responsible behaviour. External regulation is also needed, not least because people do always not behave responsibly. However, even a regulatory system based upon highly prescriptive rules will not promote public confidence in banks if the underlying system is fundamentally corrupt and lacks self-discipline.¹¹⁰⁵

The Legal Services Board stated:

This dual focus [on entities as well as individuals] is absolutely the right one. Individuals need to be given every incentive to live up to the high aspirations of their professional calling, while the firms and other entities which employ them need to be held to account for their direct statutory responsibilities [...] to enable individuals within the firm to meet their own obligations.¹¹⁰⁶

638. One lesson from the approach in those professions is that the responsibility on firms to uphold standards is integrated with the statutory regime. A regulator can set out clear expectations of what standards firms must uphold, then monitor implementation and take action if firms are found to be failing in their duties. For example, the Financial Reporting Council conducts regular reviews of major accounting firms, covering areas including “tone at the top”, “independence and ethics”, “performance evaluation and other human resource matters” and “audit quality monitoring”. The resulting reports “seek to identify

1104Q 280

1105Ev 1131

1106Ev 1578

areas where improvements are [...] needed” and “place greater emphasis on weaknesses identified requiring action by the firms than areas of strength”.¹¹⁰⁷

639. Barclays proposed that a newly-created Banking Standards Review Council should:

have responsibility for ensuring covered firms comply with their responsibilities with respect to putting the ‘code’ into practice through auditing and assessing practical application. This will be done at the firm level, not the individual, and include specifying how compliance with the ‘code’ and its application requirements will be determined, monitored and audited.¹¹⁰⁸

For reasons set out earlier in this chapter, we have concluded that a regulatory role such as this is not appropriate for a professional body in the short or medium term. However, we have concluded that Barclays have helpfully identified an important element in a new system.

640. 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.

641. 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.

642. 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.

643. 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

¹¹⁰⁷Financial Reporting Council, *Audit Quality Inspectors Annual Report 2011-12*, p 18

¹¹⁰⁸Ev 809

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.

644. 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.

645. 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

646. There is currently a register of individuals in the financial services industry who are subject to the Approved Persons Regime. The register is a public document, but provides limited information about individuals. Its weaknesses reflect those of the regime itself and the associated enforcement arrangements. We envisage the establishment of a new register underpinning the maintenance and provision of information about individuals within the Senior Persons Regime and the Licensing Regime, while operating differently in respect of the two Regimes.

647. Whereas in other professions a public register has an important role in demonstrating which individuals have successfully completed the demanding entry requirements, the absence of mandatory qualifications in banking makes this function of a register less relevant. A public register of regulated individuals can also be important in giving customers confidence about the status of the person they are dealing with, although this is less relevant in banking—where customer relationships are typically with a firm—than with financial services sectors such as independent financial advisors. Instead, the main purpose of a register in relation to individuals working in banking is to provide a record of

their employment and disciplinary history, to inform would-be employers and the regulator and to permit sanctions such as suspensions or bans to be enforced effectively.

648. The register would need to reflect any regulatory enforcement action against individuals within the Senior Persons Regime as well as those covered only by the Licensing Regime. Sir David Walker also noted the importance of a register being able to capture details about disciplinary action taken by firms themselves:

It is very important that we not only are able, but have an obligation to put on the register that the individual has been separated for a particular reason. The counterpart of that is that there would be an obligation on any bank that wished to employ that individual to consult the register and take a view about whether they wanted to employ the individual—he or she having a mark against them.¹¹⁰⁹

However, placing information about banks' own disciplinary actions on a public register to be used by prospective employers could risk abuse. Very robust safeguards against individuals and appeal processes would likely be necessary to make such a system fair and legally sound.

649. Simon Thompson, Chief Executive of the Chartered Banker Institute, noted the importance of there being a single register to hold all of this information rather than splitting it:

We would like to see a single register for bankers. I think one of the issues is individuals being members of one of many professional bodies. I think a single registration body that holds a single register that customers could check and make a complaint against would be very helpful. Clearly we would want to see proper mechanisms for bankers to be struck off that register if they misbehave. How that is done—I think there are two models. You could either look to have an extended FSA register or you could have a new independent register of banking professionals.¹¹¹⁰

650. Maintaining an accurate and up-to-date register can impose a significant burden on both firms and regulators. The FSA recommended that if the scope of the regime were to be widened to facilitate enforcement “for this wider group we could dispense with the requirements for pre-approval and registration [...] such an arrangement would not be intrusive or costly as the existing regime”.¹¹¹¹

651. 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.

1109Q 3577

1110Q 2427

1111Ev 1474

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.

The benefits of an international approach

652. Banking is a highly internationally mobile profession. Many of the individuals working in the sector in the UK are foreign nationals, and many of the banks operating in the UK are headquartered overseas. If individuals who were subject to sanctions in the UK as a result of poor banking standards could simply transfer overseas and continue their careers unhindered, the incentive effects of an enforcement regime would be significantly weakened. This problem is not unique to banking, as Sir Peter Rubin of the GMC pointed out:

we tell every medical regulator in the world when we have taken action against a doctor's registration, but it is up to them what they do with that information. Sadly, too many of them do nothing with that information [...]when I was musing earlier on the difference between bankers and doctors, I was thinking about what I would do if I wanted to get round the regulation. Well, I would move my banker somewhere else, wouldn't I? I would move my banker to a different jurisdiction, where the regulation is not as strict as it is in the UK.¹¹¹²

653. The US regulators who gave evidence indicated that there was no official mechanism for sharing information about individuals between the UK and the US, the two leading global financial centres, although the US regulators would look at any criminal convictions.¹¹¹³ They agreed that movement towards mutual recognition of sanctions would be a useful step.¹¹¹⁴ Some steps are already being taken to support the sharing of information about sanctions between European regulators.¹¹¹⁵

654. 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

1112Qq 1846 –1847

1113Qq 2877, 2879

1114Q 2880

1115Under Article 68A of the proposed new Capital Requirements Directive, national regulators would inform the European Banking Authority of sanctions imposed under certain articles of that Directive and that Authority would be empowered to provide access to a combined register on a confidential basis to other national regulators.

this issue. Subsequent discussions with the EU and other financial centres may also be appropriate.

Banking as a special case

655. The Approved Persons Regime and the accompanying register currently apply not only to banks, but to the entire financial services sector. As noted earlier the largest 19 banks and building societies in the UK account for only 26,575 people on the Approved Persons Regime register.¹¹¹⁶ This is a relatively small proportion of the estimated 156,000 individuals on the register, as Anthony Browne noted:

the Approved Persons Regime certainly needs to be made a lot more visible and be more obviously enforced to give more public confidence that it exists. There is a problem with it, which is—it is slightly frustrating for us—that they do not separate out banking from the rest of financial services. A lot of its members are financial advisers. There are 156,000 people on it. We have asked the FSA many times how many of those actually work in banks, and they cannot tell us, which is a frustration for us, because it would be a lot easier to say, “There are this many approved people on the Approved Persons Regime who work in banks.”¹¹¹⁷

656. The authorities must not be constrained, in implementing the proposed reforms relating to individuals, by the fact that the existing Approved Persons Regime and register apply to the whole financial services sector rather than just banks. Events have demonstrated why reforms are urgently needed to promote improved individual standards in banking. There may be a strong case for applying some of these reforms to other areas of the financial services sector and it is plausible to suppose that the deficiencies of the Approved Persons Regime are replicated beyond banking. However, not only does analysis of this issue lie outside the scope of the Commission’s work, but there is a risk that an extension of reform would delay the timetable for reforms, both due to the wider interests involved and the operational flaws of the current Approved Persons Regime. We therefore recommend that the arrangements for a Senior Persons Regime, for a Licensing Regime and for a register, reflecting the operation of these regimes, be put in place in the first instance separately from the Approved Persons Regime, which should cease to apply to banking. It is for the regulators to advise on the merits of the new schemes’ wider applicability.

657. In Chapter 10, we make proposals for how the Senior Persons and Licensing Regimes should form part of a more effective system of enforcement and sanctions against individuals.

1116C Ev 175

1117Q 2544

7 Bank governance, standards and culture

Introduction

658. In this chapter, we examine the governance and culture of banks, considering successively: shareholders, boards and internal control frameworks, and then wider issues relating to the culture within banks, including bank value statements and the role of whistleblowers.

659. The primary duty for maintaining high standards in banks lies with the banks themselves, and in particular their boards. They operate within a corporate governance framework of rules, guidelines and best practice for public corporations that is designed to ensure that they fulfil this duty. Corporate governance has been found badly wanting in financial institutions in the recent past, particularly in banks. This has been at great cost not just to the shareholders, but to taxpayers. There have been a number of common features of the failures of bank boards, regardless of the structures of those boards. A number of steps have been taken since the onset of the financial crisis to improve governance practice in financial institutions.¹¹¹⁸ The Commission has no wish to turn the clock back or prescribe highly detailed templates. The Commission is also realistic about the limited scope there is for achieving transformational change within banks through changes to structures of governance, but considers that there were considerable defects in corporate governance in banks that can and should be addressed. However, there are some changes we suggest below which we judge are likely to secure significant improvements to banks' governance and which are aligned with our proposals in the previous chapter on a new framework founded on the principle of individual responsibility.

Shareholders: the silent owners

The UK equity market

660. Shareholders have not been effective in disciplining or constraining banks' behaviour. This section examines why shareholders, or rather those that act for shareholders, have contributed to the crisis of banking standards, and the extent to which shareholders can be expected to be part of the solution.

661. In recent decades, the pattern of UK shareholding has become more fragmented. Insurers, pension funds and individuals have outsourced their investments to fund managers, who have come to dominate equity markets, while financial globalisation has led to a rising proportion of UK equities held by overseas investors. Professor John Kay, in his review of UK equity markets, argued that "This fragmentation has reduced the incentives for engagement and the level of control enjoyed by each shareholder".¹¹¹⁹ In many cases,

¹¹¹⁸Group of Thirty, *Toward Effective Governance of Financial Institutions*, 12 April 2012, p 5, www.group30.org

¹¹¹⁹John Kay, *The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report*, 23 July 2012, p 10, www.gov.uk

this process has further weakened active engagement by shareholders, with fund managers and overseas investors typically more interested in the short-term performance of companies than in generating sustainable returns by promoting their long-term success. Any influence they wield over the management of the company is manifested through selling their stock rather than through voting and engaging with the boards of their investee companies, a phenomenon described in the Kay review as “exit over voice”.¹¹²⁰ The table below shows how the proportion of UK-quoted shares held by insurance companies and pension funds has declined in recent decades, while overseas holdings have increased.

Historical Trends in Beneficial Ownership (Percentage Held)	1963	1975	1981	1991	2001	2008	2010
Rest of the world	7	5.6	3.6	12.8	35.7	41.5	41.2
Insurance companies	10	15.9	20.5	20.8	20	13.4	8.6
Pension funds	6.4	16.8	26.7	31.3	16.1	12.8	5.1
Individuals	54	37.5	28.2	19.9	14.8	10.2	11.5
Other	22.6	24.2	21	15.2	13.4	22.1	33.6

Source: *The Kay Review of UK Equity Markets and Long-term Decision Making, Final Report, p 31*

662. Investors that hold shares for a short period are less likely to be concerned by the long-term prospects of the company they own, other than to the extent that it affects short-term movements in the share price. Because they trade more frequently, short-term investors can exercise an influence on share prices that is disproportionate to their holdings. The rise of shareholder short-termism and disengagement from the responsibilities of ownership has been exacerbated by the growth of intermediaries that have distanced the ultimate beneficial owner of shares from investee companies.

663. The Kay review and Sir David Walker’s review of corporate governance in UK banks both considered these developments, and proposed measures to reflect better shareholders’ responsibilities as company owners. Among other recommendations, the Walker review proposed a new Stewardship Code setting out best practice in stewardship by institutional investors and fund managers.¹¹²¹ The Kay review recommended the inclusion of a commitment to responsible engagement within the investment management industry code.¹¹²² However, Professor Kay and Sir David both acknowledged in evidence to the Commission that the investment environment that they ultimately sought, in which the “anonymous trader” was replaced by the “concerned investor”, remained a long way off.¹¹²³ Professor Kay spoke of “philosophical leaps that are needed to take us to the world we would like”,¹¹²⁴ while Sir David told us that “it will not happen overnight, and it may never happen”.¹¹²⁵

1120 John Kay, *The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report*, 23 July 2012, p 21, www.gov.uk

1121 Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, p 17

1122 John Kay, *The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report*, 23 July 2012, p 45, www.gov.uk

1123 *Ibid.* P 10

1124 Q 326

1125 Q 3628

Who owns the banks and why?

664. The situation facing UK equity markets generally also applies to banks specifically. In Annex 5 we consider further evidence on bank ownership. The main points emerging from that evidence are that:

- Few entities hold large single stakes in UK banks and many have holdings in each of the large banks;
- Bank shareholdings are often held for a short time, encouraging short-term risk-taking;
- There are reasons for scepticism as to whether shareholders could spot the risks which a bank's own leadership misses; and
- Active investment can lead to higher returns, but potential active investors are wary of seeking insider knowledge.

Institutional shareholders have not done enough to encourage banks to maintain high levels of banking standards.

Shareholder pressure and leverage

665. Where shareholders did engage with banks in recent years, it was sometimes to pressurise them to take on additional risk and increase leverage to boost equity returns. RBS told us that “in some instances investors pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk”.¹¹²⁶ Lloyds said that:

Shareholder behaviour “pre-crunch” focused on a drive for growth with emphasis placed on delivering potentially unsustainable returns, without recognition of the downside risks. This was a factor in creating a culture that arguably led to failure in the sector.¹¹²⁷

In its evidence, HSBC wrote of a “very strong public call for leverage and structuring from many institutional shareholders”,¹¹²⁸ while its Chairman Douglas Flint told the Treasury Committee that:

There was a great deal of pressure coming from shareholders who were looking for enhanced returns and were pointing to business models that have, with hindsight, been shown to be flawed and in particular very leveraged business models and saying, “You guys are inefficient. You have a lazy balance sheet. There are people out there that are doing much better than you are”, and there was tremendous pressure during 2006/07.¹¹²⁹

1126Ev 1324

1127Ev 1222

1128Ev 1119

1129Treasury Committee, Ninth Report of Session 2010–11, *Competition and choice in retail banking*, HC 612, Qq 833–835

A number of witnesses noted that this misalignment of interests between shareholders and society was further exacerbated in banks deemed too big to fail because bondholders perceived to be insured against failure did not rein in the more risky instincts of shareholders. As Professor Kay put it:

banks [...] are unique among large companies in that the equity shareholders in reality only provide 2 per cent or 3 per cent of the capital of a business [...] Much of the capital is[...] in effect employed by bond holders.¹¹³⁰

Professors Black and Kershaw drew attention evidence from the US indicating that “direct or indirect shareholder pressure supported by strong shareholder rights [could result] in more risk-taking than in banks with weaker shareholder rights where managers could resist that pressure”.¹¹³¹

Conclusions

666. Institutional shareholders have unlimited upside to their investment, but a downside limited to their equity stake. Shareholders also fund only a tiny proportion of a bank’s balance sheet, which can incentivise them to encourage banks to increase short-term risks. In the run-up to the financial crisis, shareholders failed to control risk-taking in banks, and indeed were criticising some for excessive conservatism. Some bank leaderships resisted this pressure, but others did not. The Independent Commission on Banking believed that its proposed ring-fence would create incentives for shareholders to be more mindful of excessive risk. However, we agree with the Kay Review that incentives for institutional investors to engage with companies remain weak. The primary responsibility of institutional investors is to earn returns for their clients, with engagement with company managements only likely to be undertaken by firms that regard it as contributing to that responsibility. The nature of the asset management industry and the financial incentives for key decision-makers in that industry incentivise focus on short-term investment performance, rather than engagement to promote the longer term success of companies, even though the latter may be better aligned with the long-term interests of the ultimate beneficial owners of the shares. Even the largest investors own relatively small holdings in large companies such as banks, limiting their influence. The misalignment between the incentives of asset manager and the long-term interests of a company, coupled with the fact that shareholders contribute only a tiny sliver of a bank’s balance sheet, mean it would be a mistake to expect greater empowerment and engagement of shareholders to lead to the exercise of profound and positive influence on the governance of banks.

The role of bondholders

667. In addition to customer deposits most banks raise money from wholesale markets, including from private investors, institutions and other banks. Although not all strictly in the form of bonds, we use the term bondholder to encompass wholesale market providers

1130Q 344

1131Ev 832

of bank funding. The leverage of financial institutions results in bondholders and depositors providing the dominant proportion of bank funding; the sums provided by shareholders are correspondingly substantially smaller. The leverage in the banking system prior to the financial crisis was only possible because of the funding available. The 3% minimum Tier 1 leverage requirement included within the Basel III capital proposals establishes a minimum level for the Tier 1 contribution to the funding of a bank balance sheet of just 3%, with up to 97% from other sources, largely bondholders and depositors.

668. The proportions of funding raised from customer deposits and wholesale markets varies significantly between individual banks. At the end of 2012 Lloyds Banking Group had wholesale funding equivalent to 40% of its customer deposits¹¹³², down from 90% at the end of 2008¹¹³³. Barclays had wholesale funding equivalent to 71% of its customer funding at the end of 2012¹¹³⁴, compared with at the end of 2008. Regardless of this leveraged structure, the legal responsibilities of bank managements are currently similar to those of non-financial companies. The Companies Act obliges managements to manage a company in the interests of its members, which is widely interpreted to be its shareholders. Stephen Hester told us that directors have an:

obligation to act on behalf of the company's interests, prominent among which are the shareholders who own the company. So you can have any membership you like, but the board of directors will have a duty to the shareholders.¹¹³⁵

669. As owners, shareholders have significant powers, including over company governance, such as the right to approve and re-elect directors and in certain circumstances, major corporate initiatives may also require shareholder approval. By contrast, while a bank remains solvent, the formal powers of other creditors, such as bondholders, are much more limited. The terms of some bond issuances may have provisions in situations when the security of the bond may be affected. Secured creditors, such as securitised or covered bond holders, may also have claims against particular asset pools and associated rights to protect the security of those pools. However, bondholders have no general formal powers over a bank's strategy or the appointment of management. It is only in the event of insolvency that creditors assume the rights of ownership of the company, with the power to replace management and dispose of assets and to seek to recoup their exposure from any proceeds in accordance with a determined creditor hierarchy.

670. In practice, the scale of the funding provided by bank creditors means they have much more influence over companies than their formal rights would imply. Most bank funding has a fixed maturity, with only minimal sums currently in the form of irredeemable debt. Consequently, banks have to engage in regular raising of new debt funding, both to refinance maturities of existing debt and to fund new business growth. At the end of 2012, 30% of Lloyds Banking Group's wholesale funding had a remaining maturity of under one

¹¹³²Lloyds Banking Group, Annual Report and Accounts 2012, p 50, www.lloydsbankinggroup.com

¹¹³³Lloyds Banking Group, Annual Report and Accounts 2009, p 84, www.lloydsbankinggroup.com

¹¹³⁴Barclays, *Annual Report and Accounts 2012*, p 176, www.barclays.com

¹¹³⁵Q 870

year¹¹³⁶, compared with 42% at Barclays.¹¹³⁷ As a result banks have strategies to maintain as wide and ready a demand for their paper as possible. For larger banks, this generally includes a broad range of funding sources by currency, structure, maturity, geography and investor type. This process generally involves engagement with a broad range of bond investors, analysts and rating agencies. Bank managements therefore need to respect the views of bond markets and the resulting impact on the appetite for their paper of the actions they take. The attention banks have devoted to funding markets has increased substantially over the financial crisis and subsequently, as liquidity has become much less reliable; there have been periods when liquidity almost completely evaporated and volumes in certain areas, such as mortgage securitisation, have shrunk dramatically from the pre crisis period.

671. The characteristics and interests of bondholders and shareholders are very different. Shareholders' potential upside is unlimited and in return for this, they are prepared to assume greater risk and rank behind all creditors in the case of insolvency. Bondholders are normally more risk averse than shareholders. They rank ahead of shareholders in the case of insolvency and are prepared to forgo the unlimited upside potential of shareholders in return for this additional security. Bondholders generally only expect to receive a return of their investment plus interest for the intervening period. As their upside is largely capped, bondholders are likely to be more cautious of potential risks to the downside. Shareholders' upside ultimately derives from business growth. Bondholders' security relies on the bank's stability.

672. The incentives for bondholders to discipline banks depend on the risks they perceive. Given the substantial leverage maintained by banks, insolvency can still result in significant losses to bondholders, despite the protection of shareholder capital. Fear of such losses can incentivise bondholders to limit the risks banks take. However, if bondholders regard the risks as small, particularly due to the perception of the existence of an implicit or explicit taxpayer guarantee, these incentives are correspondingly reduced. This may particularly apply to banks that are regarded as too big to fail.

673. Proposals for structural reform of the banking industry are set out in Chapter 4 of this Report. Many of these reforms are at least partly aimed at reducing or eliminating the perceived taxpayer guarantee. The reforms include the potential power to 'bail in' categories of bondholders. However, as we also state in this section, there is convincing evidence that the guarantee may not be fully eliminated, even once all the proposed reforms take full effect.

674. The financial crisis has underlined, if this were needed, the importance of effective scrutiny and the exercise of discipline by creditors to the maintenance of banking standards. Such discipline has been lacking, in large part as a result of the perceived taxpayer guarantee. The measures to bear down on the guarantee, which the Commission has already noted should be a priority, would be the most effective way of correcting this, as bondholders, broadly defined, would have a greater incentive

1136Lloyds Banking Group, *Annual Report and Accounts 2012*, p 50, www.lloydsbankinggroup.com

1137Barclays, *Annual Report and Accounts 2012*, p 176, www.barclays.com

properly to assess credit risk. Market discipline from creditors subject to the potential of bail-in should encourage banks and their managements better to balance downside and upside risks. The Commission endorses the good practice adopted by an increasing number of banks of publicly disclosing, and making widely available, the contents of their presentations to bondholders. The Commission encourages bondholders, where they are sufficiently concerned, to raise such issues publicly where practical. The PRA should examine the scope for extending bondholder influence of this type.

Bank boards and governance

Introduction

675. UK corporate governance has improved in recent years. But when in the case of banks it was tested, it was found wanting. Board failures in the banking sector have been widespread and are not restricted to those banks which required taxpayer support or failed during the financial crisis. Crucially, board governance failures have also been prevalent in some banks which emerged relatively unscathed by that crisis. This section examines the role of the board in the context of wider corporate governance failures in the banking sector. We examine why over the last decade so many banks boards appeared unable to operate effectively; the key factors which underpinned this failure; and whether reforms to the way bank boards are governed are sufficient to ensure they prove more effective in the future.

676. There is no quick single fix to improve banks' governance. Equally, a collection of detailed tweaks is unlikely to prevent serious failures such as the banking industry has experienced. We are cautious about making a great many recommendations in this field which may do little more than create yet more lucrative work for corporate governance professionals. We therefore concentrate on assessing proposals for change against four basic principles, which are connected: ensuring personal responsibility of board members; ensuring that there is adequate challenge within boards; preventing boards from constructing internal firewalls that leave them in wilful ignorance and excuse them from proper accountability for the firm; and reflecting the differences between banks and other public companies arising from the fact that shareholder equity represents only a tiny sliver of the balance sheet.

677. Box 12 sets out the role of a company board and the functions of a number of the committees of a board.

Box 12: The role of the board and the combined code on corporate governance

The UK Corporate Governance Code states that “every company should be headed by an effective board, which is collectively responsible for the success of the company”.¹¹³⁸ Boards typically comprise both executive and non-executive directors, including a chief executive and chairman. Furthermore, as regards “division of responsibilities”¹¹³⁹ on the board, the code states that:

- There should be a clear division of responsibilities at the heart of the company between the running of the board and the executive responsibility for the running of the company’s business. No one individual should have unfettered powers of decision;
- The Chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role;
- As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy;
- With regard to ensuring the “effectiveness” of the board, the code states that:
- The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively; and
- All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.

Bank board committees

Bank boards tend to typically organise and manage their governance through committee structures. The most common committees at banks are the Audit Committee, Risk Committee, Nomination Committee, and Remuneration Committee.

The main roles and responsibilities of the **Audit Committee** includes monitoring the integrity of the financial statements, reviewing internal controls, monitoring and reviewing the effectiveness of the internal audit function and overseeing the relationship with the external auditor.

The role of the **Risk Committee** can differ between institutions. In HSBC, the Group Risk Committee is responsible for ‘advising the Board on high level risk-related matters and risk governance and for non-executive oversight of risk management and internal controls (other than financial reporting).’¹¹⁴⁰ In Barclays, there are three different risk committees responsible for different aspects of risk: the Board Conduct, Reputation and Operational

¹¹³⁸Financial Reporting Council, *The UK Corporate Governance Code, September 2012*, p 7, www.frc.org.uk

¹¹³⁹Financial Reporting Council, *The UK Corporate Governance Code, September 2012*, p 9, www.frc.org.uk

¹¹⁴⁰“Board committees”, *HSBC*, 2013, www.hsbc.com

Risk committee; the Board Financial Risk Committee; and the Board Enterprise Wide Risk Committee.¹¹⁴¹

The **Board Remuneration Committee** ‘sets the overarching principles and parameters of remuneration policy’¹¹⁴², monitors and approves the remuneration arrangements of the executive directors and senior executives and ‘ensures that the remuneration policy is appropriate and consistent with effective risk management’¹¹⁴³.

The **Nomination Committee** leads the process for Board appointments and identifies and nominates candidates, for the approval of the Board. They are responsible for reviewing the composition of the Board and considers the succession plan for the key Board positions like the Chief Executive and the Chairman. In the case of Barclays, Lloyds Banking Group and RBS, the Nomination Committee is chaired by the Chairman of the board.

The nature of the failures

678. The record of board governance failures in the preceding years is well-documented and does not need to be rehearsed again in detail.¹¹⁴⁴ A few examples will suffice. The Treasury Committee, in its Report *The Run on the Rock*, concluded with respect to the Northern Rock board:

Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.¹¹⁴⁵

Similarly, this Commission highlighted board failures in its report on the collapse of HBOS:

The corporate governance of HBOS at board level [...] represents a model of self-delusion, of the triumph of process over purpose.[...] The Board, in its own words, had abrogated and remitted to the executive management the formulation of strategy, a matter for which the Board should properly have been responsible.¹¹⁴⁶

Boards failed to maintain high levels of professional standards and did little to prevent mis-selling scandals such as PPI and IRHP.

1141 “The Board Committees”, *Barclays*, 2013, www.barclays.com

1142 “Remuneration Committee - Terms of Reference”, *Lloyds Banking Group*, 2013, www.lloydsbankinggroup.com

1143 Standard Chartered, *Annual Report and Accounts 2012*, www.reports.standardchartered.com

1144 Group of Thirty, *Toward Effective Governance of Financial Institutions*, 12 April 2012, p 12, www.group30.org; Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities*, Final recommendations, November 2009, paras 1.8 and 1.10

1145 Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56-I, para 31

1146 Fourth Report, paras 91 and 92

Why banks are different

679. Bank boards face particular challenges and responsibilities compared to other organisations. These primarily reflect the systemic risks associated with banking, and also specific regulatory requirements to mitigate conduct risk. As a result of their ‘too important to fail’ status, banks benefit from an implicit subsidy which we have discussed in greater detail previously in this Report. This implicit subsidy—based upon the expectation of taxpayer support—has led to significant taxpayer bail-outs of some banks as well as other forms of support to the banking sector as a whole. Professor Julian Franks summarised why banks were different:

What is different about banks is that they give rise to tremendous systemic risks. Whereas BP can destroy itself but the taxpayer does not bail the company out, it is the preponderance of leverage and the failure that gives rise to systemic risk that make banks different.¹¹⁴⁷

Dr Peter Hahn focused on risk profile as a key differentiator. He told us that “they (banks) are fundamentally different in an extraordinary way” as, in comparison to other industries, they can change their risk profile very quickly. He said:

Banks, however, are fundamentally risk management businesses; their business is to try to match risk and return on a daily basis. [...] the challenge is that it is very hard for many large businesses to change their risk profile very quickly, and a bank could take on unbelievable amounts of risk in a few moments.¹¹⁴⁸

680. The complexity of banks led some witnesses to express scepticism that it was possible for a bank board to work as effectively as was the case in other sectors. This was the Governor’s stance: certain “institutions were simply too big and complex for anyone to genuinely know exactly what was going on”.¹¹⁴⁹ Professor Julian Franks told the Commission:

That adds to my view that banks are complex and if you think that you can fix boards to fix these problems, that is a great mistake. You need structural changes. We can improve boards, but do not lay too much emphasis on that as a way of stopping the problem [...].¹¹⁵⁰

[large] banks are very complex organizations and increasingly I am coming to the view that bank boards do not have the information to pinpoint problems early enough. Problems of fraud, misselling as well as excessive leverage should tell us that with the best of directors some banks are simply too complex for boards to manage with confidence.¹¹⁵¹

1147CQ 1

1148CQ 2

1149Q 4554

1150CQ 9

1151C Ev 139

The importance of the challenge function

681. A key theme to emerge in our work on corporate governance was the importance of non-executive directors exercising a ‘challenge’ function with respect to executives and acting as an effective check and balance on senior management. This ‘challenge’ function is set out in the Code, which states that “non-executive directors should constructively challenge and help develop proposals on strategy¹¹⁵² [...] [as well as] scrutinise the performance of management in meeting agreed goals and objectives. They should satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust and defensible”.¹¹⁵³ However, as the Treasury Committee has previously concluded:

The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector. In particular, the evidence shows that many non-executive directors—in many cases eminent and highly-regarded individuals with no shortage of experience in the business and banking worlds—failed to act as an effective check on, and challenge to, executive managers. Too often non-executive directors in the banking sector have operated as members of a ‘cosy club’ rather than viewing their role as being that of providing effective checks and balances on executive members of boards.¹¹⁵⁴

Cevian Capital stressed the importance of ‘challenge’ in ensuring that boards worked effectively. It stated that “lack of challenge in the boardroom [...] leads to poor decision-making, limited accountability and improper alignment of interests”. The consequences, it noted, were “particularly grave in the financial sector—where the job of a non-executive director is especially difficult—given that relative to part-time NEDs, executive directors have a huge informational advantage and benefit asymmetrically from risk-taking”.¹¹⁵⁵

682. Sir David Walker pointed out the reactive and passive nature of too many boards:

Boards driven in many cases by a concern about short-term profit and loss and the quarterly earnings announcement, have in my view been too passive and accepting of what was proposed by the executive.¹¹⁵⁶

In his review of corporate governance arrangements at major financial institutions, Sir David stressed the paramount importance of ‘challenge’ in the boardroom:

‘The essential challenge’ [...] appears to have been missed in many board situations and needs to be unequivocally clearly recognised and embedded for the future. The most critical need is for an environment in which effective challenge of the executive

1152 Financial Reporting Council, *The UK Corporate Governance Code*, September 2012, p 6, www.frc.org.uk

1153 *Ibid.* p 10

1154 Treasury Committee, Ninth Report of Session 2008–09, *Banking Crisis: reforming corporate governance and pay in the City*, HC 519, para 151

1155 Written evidence from Cevian Capital to the Treasury Committee, May 2012 (CGR 31) [not printed], www.parliament.uk/treascom

1156 Q 17

is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues.¹¹⁵⁷

Sir David, expanded on these points in evidence to the Treasury Committee noting that “one way of characterising corporate governance in financial institutions before the crisis [...] is that certainly in this country—but I believe elsewhere and particularly in the USA—they were far too collegial”. As a result, “the word I have been very keen to deploy and promote, greatly irritating some, is ‘challenge’”.¹¹⁵⁸

683. David Paterson, Head of Corporate Governance at the NAPF, told the Treasury Committee that it was “an enormous challenge” to ensure that non-executive directors acted as an effective check and balance on executives. He argued that it “requires a strong chairman to elicit the views of non-executive directors and to encourage them to speak up, either in the board meeting or privately to him, about concerns they have”.¹¹⁵⁹ Otto Thorensen, Director General of the ABI, concurred, telling the Treasury Committee that “the role of the Chairman is absolutely critical” in ensuring a well-functioning board where effective challenge takes place. However, Mr Thorensen also stressed the importance of the chief executive in accepting such challenge as well as the role of the “executive team in supplying the right kind of information in a way that people can understand”.¹¹⁶⁰ The problems of boards which become overly-collegiate was made by Martin Taylor who told us that “the culture you want on a board is a bracing culture”, but that the default culture of:

Collegiality [...] comes from our social habits. Man is a social animal. You have dinner with people the night before and one of them says, “Do you want to borrow my house in Tuscany and the rest of it?” It doesn’t happen to me, but you know what it mean. Then the next day at the board meeting, do you say to them, “Look, I have three questions for you and I’m not going to stop until you’ve answered all three of them properly”? People don’t do that.

A bank company secretary told us that, in his view, bank directors prefer driving strategy to acting as a policeman, but they did recognise that it was an important responsibility which was increasingly dominating their time.

684. Both the financial crisis and conduct failures have exposed very serious flaws in the system of board oversight of bank executives and senior management. The corporate governance of large banks was characterised by the creation of Potemkin villages to give the appearance of effective control and oversight, without the reality. In particular, many non-executive directors—in many cases experienced, eminent and highly-

1157 Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, p 9

1158 Uncorrected transcript of oral evidence taken before the Treasury Committee on 22 May 2012, HC (2012–13) 72-i, Q22

1159 Uncorrected transcript of oral evidence taken before the Treasury Committee on 19 June 2012, HC (2012–13) 72-iii, Q 139

1160 *Ibid.* Q 141

regarded individuals—failed to act as an effective check on, and challenge to, executive managers. Our work on HBOS provided considerable evidence of this failure.

Proposals for change

685. Many experts have argued that improving the effectiveness of boards is the key to addressing many of the problems in the banking sector. For example, the corporate governance consultancy PIRC has spoken of the importance of addressing board failures which they suggested had been neglected by policymakers in their examination of the financial crisis. It proposed that:

consideration is given to the role and responsibility of the boards of banks. Too much commentary on the banking crisis has overlooked or underplayed the primary responsibility that the boards of banks have for their own failures. While it is of course right to consider the role of regulators and central banks, the board members of the banks that have run into difficulties must take their full responsibility too. They approved the business strategies and products that have caused such damage after all.¹¹⁶¹

686. In the aftermath of the financial crisis, the then Government asked Sir David Walker to examine the issue of corporate governance in large complex financial institutions. He made a series of recommendations to improve governance in such firms, including some which related directly to the role and effectiveness of the board. Amongst the more significant were:

- providing for dedicated support for NEDs on any matter relevant to the business on which they require advice separately from or additional to that available in the normal board process; and
- that the overall time commitment of NEDs as a group on a FTSE 100-listed bank or life assurance company board should be greater than has been normal in the past. For several NEDs, a minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of an individual non-executive director to retain or assume board responsibilities elsewhere.

The implementation of the Walker proposals has taken place in parallel with banks' own initiatives for change in this area.

687. However, some have argued that these amendments to the UK Corporate Governance Code have not gone far enough and that further changes are required to improve the effectiveness of bank boards and, in particular, ensure non-executive directors are both more able and more willing to exercise their crucial challenge function. The Commission has considered a number of these ideas, including:

- changes to the structure of boards;

¹¹⁶¹Treasury Committee, Ninth Report of Session 2008-09, *Banking Crisis: reforming corporate governance and pay in the City*, HC519, Ev 252

- changes to the size of boards;
- changes to the composition of boards;
- changes in the way boards are selected; and
- a new fiduciary duty on members of bank boards.

Changes to the unitary board structure of UK banks

688. The UK has traditionally operated a unitary board structure.¹¹⁶² In other countries such as Germany, however, the supervisory two-board structure has been prevalent. This system consists of a supervisory board of non-executive directors and a separate management board of executive directors. We asked whether one particular construct was superior to the other and whether the UK should consider moving towards a supervisory board structure. This issue had previously been examined by Sir David Walker who concluded against change in this area.¹¹⁶³ The Treasury Committee has also previously looked at this issue, where the overwhelming majority of responses supported retention of the unitary board, while only a small number of responses argued in favour of the merits of a two-tier or a dual board. However, even those who advocated retention of the present system acknowledged that it had flaws. For example, Board Intelligence argued:

We wonder whether the unitary structure may be an obstacle to the board's fulfilment of its role as 'supervisor'. [...] The challenge of supervising a peer in the unitary board structure is aggravated by the asymmetry of information between executives and non-executives: with knowledge comes power and given the time they spend in the business, the executive holds the balance.¹¹⁶⁴

689. Crucially, the CBI pointed out that no specific board structure was resistant to the financial crisis:

The CBI does not believe that adopting a different Board structure in financial institutions in the UK would lead to better governance. No single board structure was resistant to the financial crisis, with unitary, two-tier and alternative Board structures all having the potential to fail.

It argued that the unitary board structure had important benefits:

[it] promotes collective responsibility for decision-making, and non-executive directors can challenge and develop proposals on strategy. We believe that two-tier boards are susceptible to a lack of consistency, communication gaps and slow decision-making.¹¹⁶⁵

¹¹⁶²The two-tier board model is already an optional alternative in the UK since company law does not exclude it.

¹¹⁶³Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009

¹¹⁶⁴Ev 836

¹¹⁶⁵Written evidence from the Confederation of British Industry to the Treasury Committee (CGR 16), May 2012 [not printed], www.parliament.uk/treascom

Marcel Rohner, the former CEO of UBS AG, noted that the dual board structure of UBS failed:

I think this idea of governance in two tiers is a good idea in good times. My personal impression was in a crisis of the magnitude we went through, it is dysfunctional. It does mean that the supervisory board has all the responsibility, but they cannot act operationally.¹¹⁶⁶

690. Much of the evidence suggested that issues to do with board structure were secondary and that the focus needed to be on incentivising the right behaviours. For example, Hermes Equity Ownership Services stated:

We favour a focus on these behavioural aspects rather than the structural issues; using structural methods to address behaviour is less likely to produce a good outcome than focusing on the behaviour itself.¹¹⁶⁷

Its stance mirrors that of the G30 who concluded that “well implemented governance structures and processes are important, but whether and how well they function are the essential questions”.¹¹⁶⁸

Board size

691. Another debate after the financial crisis was whether UK bank boards had become too large and therefore too unwieldy. The Walker review noted research which showed that:

UK-listed banks have much bigger boards and that the median bank board size has increased from 15 in 2002/03 to 16 in 2007/08, whereas the average board size across the whole of the FTSE 100 has decreased from 11 to 10 over the same period.¹¹⁶⁹

For example, in 2008, Barclays Plc had a 17 member board, with 4 executives and 13 NEDs. Similarly, RBS had an 18 member board.¹¹⁷⁰

692. The Walker review examined this issue, but made no specific recommendations on the ideal size of bank boards. It did, however, note the “widely-held view that the overall effectiveness of the board, outside quite a narrow range, tends to vary inversely with its size. That view would probably tend to converge around an ‘ideal’ size of 10-12 members”.¹¹⁷¹ Post-crisis, bank boards have generally decreased in size. For example, both RBS and Barclays currently have boards with 12 members apiece. Martin Taylor told us:

1166Q 2137

1167Written evidence from Hermes Equity Ownership Services to the Treasury Committee (CGR 20), May 2012 [not printed], www.parliament.uk/treascom

1168Group of Thirty, *Toward Effective Governance of Financial Institutions*, 12 April 2012, p 13, www.group30.org

1169Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, p 41

1170RBS, *Annual Report and Accounts 2008*, p 155, www.investors.rbs.com

1171Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, p 41

I have a personal preference for smaller boards, and arguably, in complex financial companies, more knowledgeable and deeply involved boards (I allow that we seem to have moved since c .2000 in the direction of more knowledgeable directors, and so far it seems to have done no good at all). Having half as many directors paid twice as much and spending twice as much time in the business would seem to me likely to produce less bad results.¹¹⁷²

Stilpon Nestor, Managing Director of Nestor Advisers, argued there was a high degree of correlation between performance of banks and the size of their boards:

In a nutshell, Nestor Advisors 2012 research on the 25 largest European banks suggest that boards of the best-performing banks are on average smaller and more ‘mature’ [...] we find that large boards are more prevalent among the worst-performing banks, while smaller boards are clearly in the majority in our top two tiers.¹¹⁷³

Interestingly, however HSBC and Standard Chartered have maintained relatively large boards of 16 and 19 respectively at the end of 2012.¹¹⁷⁴

Improving the skills and competence of boards

693. Increased scrutiny of the composition of bank boards in the aftermath of the financial crisis has resulted in the argument being advanced that the boards of banks, owing to their complexity and systemic importance, require greater industry representation and sector-specific expertise compared with boards operating in other sectors. A different view was that many bank boards and, in particular, non-executive directors, lacked diversity. This, it was argued, had resulted in ‘group think’ and the development of a ‘herd mentality’.

694. The Walker review looked at the case for greater expertise as well as greater diversity and the potential underlying tension between the two. On the one hand, it supported moves towards greater expertise:

The combination of complexities in setting risk strategy and controlling risk and the potentially massive externalities involved in failure of a major financial entity means that the need for industry experience on BOFI [banks and other financial industry entities] boards is greater than that in non-financial business—such as pharmaceuticals, defence, energy and retailing—where the principal impact of failure will be on shareholders and, possibly, major creditors, rather than society more widely.¹¹⁷⁵

1172C Ev 148

1173C Ev 131

1174HSBC, *Annual Report and Accounts 2012*, p 310, www.hsbc.co.uk; Standard Chartered, *Annual Report and Accounts 2012*, p 137, www.standardchartered.com

1175Sir David Walker, *A Review of corporate governance in UK banks and other financial industry entities*, 26 November 2009, p 43

On the other hand, the Walker Review noted that “while a majority of NEDs should be expected to bring materially relevant financial experience [...] there will still be scope and need for diversity in skillsets and different types of skillset and experience”.¹¹⁷⁶

695. Much of the evidence stressed the importance of sector-specific expertise. Dr Peter Hahn told us that bank boards dominated by former bankers was to be expected, as complex risk knowledge was required and such expertise was rarely found outside financial institutions.¹¹⁷⁷ Some banks also appear to have recognised the need for greater bank experience on boards. For example, Barclays told the Commission that, while it had believed that “the Board needs a diverse range of skills and experience, as well as financial services experience”, it has agreed that “50 per cent of NEDs, including the Group Chairman and Chairmen of the principal Board Committees, should have banking/ and or financial services experience.”¹¹⁷⁸

696. Otto Thoresen, Director General of the Association of British Insurers, cautioned against allowing the board pendulum to swing too far in favour of expertise and against that of diversity. He told us that an emphasis on industry-specific expertise could mean that “people would be less inclined to step forward for non-executive roles in financial institutions if they felt themselves not to be technically competent enough to carry out their duties”. He warned that the result could be “a concentration of non-executives who are drawn from more technical backgrounds, with the consequence that diversity begins to be undermined”.¹¹⁷⁹ David Paterson, Head of Corporate Governance, National Association of Pension Funds, when asked specifically about gender diversity on boards, said it should be viewed in the context of the wider debate on diversity:

What we are looking for here is diversity of experience, of skills and so on, on boards and to accept that, as part of that process, more women on boards would be a very important development, frankly. I would like to see more diversity on boards and I think that going down the ‘more women on boards’ route is a very productive one. That, in itself, will deliver not just gender by diversity, but also by skill base and the rest.¹¹⁸⁰

697. Boards staffed with increased numbers of NEDs with direct banking expertise should not, however, be viewed as a panacea. In its evidence to the Treasury Committee, the Chartered Insurance Institute pointed out that RBS had notable experience on the Board but still failed to conduct the right due diligence in the ABN AMRO acquisition:

1176 Sir David Walker, *A Review of corporate governance in UK banks and other financial industry entities*, 26 November 2009, p 45

1177 C Ev 137

1178 C Ev 37

1179 Uncorrected transcript of oral evidence taken before the Treasury Committee on 19 June 2012, HC (2012–13) 72–iii, Q 144

1180 *Ibid.*, Q 157

Perhaps the most obvious example of this was RBS's takeover of ABN AMRO which took place without any due diligence of ABN's assets, despite the notable experience of many members of the RBS board.¹¹⁸¹

698. Martin Taylor appeared sceptical as to the importance of this debate. He cautioned against the view that more expert NEDs would radically transform the governance of such firms:

On the boards of banks, I have seen bank boards get more professional in the sense that more people on the bank boards have industry experience, and seven or eight years ago, it was felt that that would make them more effective. It hasn't done, or it didn't do. I think it is very difficult to sit on the board of one of these banks as an outsider. You know so little.¹¹⁸²

Who should select boards?

699. Cevian Capital, a fund manager, noted that “in the UK, the nomination process for NEDs is typically controlled by company chairmen, and the shareholder approval vote is almost always an empty formality”. Consequently, Cevian argued:

chairmen effectively select their own NEDs. Human nature means most chairmen will avoid selecting ‘natural challengers’, and most NEDs —having been given their job by the Chairmen— are uncomfortable making waves.¹¹⁸³

ShareSoc, an organisation which represents individual shareholders, took a similar view:

It is clear to us that the existing arrangements for board structure, and particularly the nomination of directors, create major problems. In practice directors solely determine who will be appointed as directors (i.e. they appoint themselves), and also determine their own pay (via Nomination Committees and Remuneration Committees that are not independent but solely consist of the same directors).¹¹⁸⁴

700. Both Cevian Capital and ShareSoc argued that the solution lay in giving shareholders a far more prominent role in selecting the board. Cevian argued that “involving large shareholders directly in the nomination process would directly address the fundamental flaws in the current system”, and was “the most tangible and realistic way to comprehensively address poor board performance”. It argued that:

this system operates well in Sweden (as well as in Norway and at most large companies in Finland) and benefits all—shareholders, companies, directors and society at large. While it would be inappropriate to simply take the Swedish system

1181Written evidence from Chartered Insurance Institute to the Treasury Committee, May 2012 (CGR 09) [not printed], www.parliament.uk/treascom

1182Q 408

1183Written evidence from Cevian Capital to the Treasury Committee, May 2012 (CGR 31) [not printed], www.parliament.uk/treascom

1184Written evidence from ShareSoc to the Treasury Committee, May 2012 (CGR 15) [not printed], www.parliament.uk/treascom

and apply it to the UK, there are important lessons that can be drawn from the Swedish experience.¹¹⁸⁵

701. Both Baroness Hogg and Sir David Walker expressed scepticism about the applicability of the Swedish model to the UK. Sir David Walker spoke of how “the Swedish model of involvement of shareholders in nomination committees is specifically appropriate to Sweden, because there are very few shareholders”. Baroness Hogg was unconvinced “that shareholders are going to do a better job than the nominations committee. Shareholders are pretty inclined to like names they know on the boards of other companies”.¹¹⁸⁶

Fiduciary duty

702. Company directors have duties under the Companies Act to promote the success of the company primarily for the benefit of shareholders. A number of witnesses argued that this meant boards placed too much emphasis on achieving this objective to the detriment of other issues. Martin Taylor stated:

It does rather feel as though bank boards—before the crisis—went along with the idea that their only duty was to shareholders; otherwise they would hardly have countenanced the rapid expansion in balance sheet size, and balance sheet leverage, that in fact took place.¹¹⁸⁷

Lord Turner told us:

We simply have to get bankers to care more about the downside as well as the upside. They need to strike different risk–return balances from those that are appropriate in some other sectors of the economy.¹¹⁸⁸

In its submission to the Commission, the FSA said:

society has an interest in ensuring that the executives and directors of banks make different decisions about the balance between risk and return than would be appropriate in other sectors of the economy.¹¹⁸⁹

Davis, Polk Wardwell told us that directors of insured US banks were required to take account of the interests of other parties than just shareholders in discharging their duties.¹¹⁹⁰

¹¹⁸⁵Written evidence from Cevian Capital to the Treasury Committee, May 2012 (CGR 31) [not printed], www.parliament.uk/treascom

¹¹⁸⁶Uncorrected transcript of oral evidence taken before the Treasury Committee on 22 May 2012, HC (2012-13) 72-i, Q33

¹¹⁸⁷C Ev 148

¹¹⁸⁸Q 1014

¹¹⁸⁹Ev 1039

¹¹⁹⁰FR Ev 46

Conclusions on boards

703. Failures of board governance have taken place in firms with very different models of corporate governance, in banks with two-tier boards as well as those with unitary boards, and in banks whose boards, whether of the US or UK type, differ significantly both in terms of size, composition and the amount of time non-executives devote to their roles. Banks whose board-level governance arrangements could be described on paper as approximating to best practice have run into serious governance problems. There were frequently several common elements to bank governance failures. Some CEOs were overly dominant, which the Board as a whole failed to control. Chairmen proved weak; often they were too close to, and became cheerleaders for, the CEO. NEDs provided insufficient scrutiny of, or challenge to, the executive, and were too often advocates for expansion rather than cautioning of the risks involved. There was insufficient wider banking experience among NEDs and the resources available to them were inadequate. Central functions, including risk and control, had insufficient capability and status to perform their functions and were often regarded as an impediment to the business, rather than essential to its long-term success.

704. We have taken a great deal of evidence advocating a range of measures which witnesses argued would improve the effectiveness of bank boards. Some have suggested a move to a two-tier board structure is necessary. Others have argued in favour of changes to the composition of boards with an emphasis on greater sector-specific expertise or in some instances greater diversity. We have heard arguments in favour of greater prescription in terms of the time devoted by non-executives to their role, the benefits of an enhanced role for shareholders in board appointments or the importance of board effectiveness reviews as a tool to improve board effectiveness.

705. Proponents of corporate governance solutions can be prone to overestimate the benefit that their particular favoured measure will provide. Structural or procedural changes to bank boards would not have prevented the last crisis and will not prevent the next one. Nevertheless, the Commission has a number of proposals which, taken together, we believe will help to bring about a desirable change in the culture and overall approach of boards.

706. The Commission recommends that the Financial Reporting Council publish proposals, within six months of the publication of this Report, designed to address the widespread perception that some 'natural challengers' are sifted out by the nomination process. The nomination process greatly influences the behaviour of non-executive directors and their board careers. Fundamental reform may be needed. The Commission considers that the Financial Reporting Council should examine whether a Nomination Committee should be chaired by the Chairman of a bank or by the Senior Independent Director.

707. There is a danger that the non-executives directors of banks are self-selecting and self-perpetuating. In the interests of transparency, and to ensure that they remain as independent as possible, the Commission recommends that the regulators examine the

merits of requiring each non-executive vacancy on the board of a bank above the ring-fence threshold to be publicly advertised.

708. The obligations of directors to shareholders in accordance with the provisions of the Companies Act 2006 create a particular tension between duties to shareholders and financial safety and soundness in the case of banks. For as long as that tension persists, it is important that it be acknowledged and reflected in the UK Corporate Governance Code, in the PRA's Principles of Business and under the Senior Persons Regime. The Commission has several recommendations in the light of this, which should at the very least apply to banks above the ring-fence threshold.

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

Individual responsibility

709. As discussed in Chapter 3, a culture exists in banking which diminishes a sense of personal responsibility. What we have referred to as the 'accountability firewall' has developed, which has served to prevent those on boards having a strong sense of personal engagement with and responsibility for failings and misconduct in the firm. Restoring a sense of individual responsibility to members of the board has the potential to improve the effectiveness of board governance and standards within the industry.

710. In Chapter 3 we outlined our proposals for a new Senior Persons Regime, to replace the SIF element of the Approved Persons Regime (APER), addressing the fundamental weaknesses with the past industry and regulatory approach to individual responsibility at the highest level. The Senior Persons Regime is designed to ensure the allocation of specific responsibilities to specific post or office holders that will place beyond doubt what responsibilities are held by whom. We discuss these responsibilities for members of the board in greater detail below, with a particular emphasis on the responsibilities of the Chairman of a bank board, given the particular importance of the role he or she occupies.

Responsibilities of the Chairman

711. The Chairman plays a crucial role. As the UK Corporate Governance Code states, “the Chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role”. The Code also states that the Chairman “should also promote a culture of openness and debate by facilitating the effective contribution of non-executive directors in particular and ensuring constructive relations between executive and non-executive directors”.¹¹⁹¹ This point has been stressed on numerous occasions. For example, the Financial Reporting Council has stated that “good boards are created by good chairmen. The chairman creates the conditions for overall board and individual director effectiveness”.¹¹⁹² Similarly the ABI in its report on board effectiveness concluded that:

The chairman is key to an effective board. There is no ‘one size fits all’ approach to the role, with different chairmen having different approaches based on what is best for the individual company and board. However there was a significant amount of consensus about the role and responsibilities of the chairman.¹¹⁹³

712. The importance of the Chairman’s role should be reflected in the post’s responsibilities under the proposed Senior Persons Regime. Chairmen should have specific overall responsibility for leadership of the board as well for ensuring, monitoring and assessing its effectiveness. This should include a responsibility for promoting an open exchange of views, challenge and debate and ensuring that other non-executives have the tools, resources and information to carry out their roles effectively, particularly their challenge function. It should be the duty of the Chairman to hold annual meetings with the chairmen of every board sub-committee separate from any attendance at meetings to ensure that he or she has an overview of the subject area within those sub-committees’ responsibility. Bank Chairmen should in future have an explicit responsibility for setting standards and providing effective oversight over how they are embedded through the organisation. In addition, it is essential the Chairman has a responsibility to ensure that he or she, together with his or her office, provides a genuine check and balance to the executives.

713. The Walker review concluded that:

The Chairman of a major bank should be expected to commit a substantial proportion of his or her time, probably around two thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the bank Chairmanship role would have priority over any other business time commitment. Depending on the balance and nature of their business, the required time commitment should be proportionately less for the Chairman of a less complex or smaller bank, insurance or fund management entity.¹¹⁹⁴

¹¹⁹¹Financial Reporting Council, *The UK Corporate Governance Code*, September 2012, p 9, www.frc.org.uk

¹¹⁹²Financial Reporting Council, *Guidance on Board Effectiveness*, March 2011, p 2, www.frc.org.uk

¹¹⁹³ABI, *Report on Board effectiveness*, December 2012, p 5

¹¹⁹⁴Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, p 58

In practice many large banks have moved towards a position where the Chairman is nearly or wholly full-time. For example, HSBC has an executive full time Chairman and the Barclays Chairman is committed to serving at least 4 days a week.¹¹⁹⁵

714. Opponents of the proposal that the Chairman of a large bank should be full-time or nearly full-time have previously argued that there is a risk that this would effectively result in the individual concerned becoming an executive with all the attendant risks of going native and a corresponding loss of independence. Dr Peter Hahn explained that the crucial issue was not whether Chairmen was full time, but rather the role they played:

Executives and managers, by definition, make the day to day decisions of the bank. That is the distinction. Where an important role, such as chairman of the board committee, requires near full time commitment non-executive status can be maintained. The critical point to maintain non-executive status and function is the maintenance and prioritisation of oversight.¹¹⁹⁶

715. We have received no evidence that a two-thirds time commitment has led chairmen of major banks to ‘go native’, and believe that the risk of this occurring with a full-time Chairman may have been overstated. In any case, the risks of partial disengagement are likely to be greater. The accountability and personal responsibility of Chairmen will be enhanced if they are engaged on a near full-time basis. In light of the crucial role played by the Chairman of a major financial institution, the Commission recommends that a full-time Chairman should be the norm. The implication of our proposals is that the Chairman of a large bank should usually not hold any other large commercial non-executive, let alone executive, positions.

Responsibilities of the Senior Independent Director

716. The Senior Independent Director (SID) plays a pivotal role on the board. In large part, this flows from the SID’s role in acting as a check on the Chairman and ensuring that the Chairman is discharging his leadership responsibilities effectively. The Walker review outlined the role of the Senior Independent Director as follows:

The role of the Senior Independent Director (SID) should be to provide a sounding board for the Chairman, for the evaluation of the Chairman and to serve as a trusted intermediary for the NEDs, when necessary. The SID should be accessible to shareholders in the event that communication with the Chairman becomes difficult or inappropriate.

717. The Commission recommends that the Senior Independent Director should, under the proposed Senior Persons Regime, have specific responsibility for assessing annually the performance of the Chairman of the board and, as part of this, for ensuring that the relationship between the CEO and the Chairman does not become too close and that the Chairman performs his or her leadership and challenge role. We would expect the regulator to maintain a dialogue with the Senior Independent

¹¹⁹⁵C Ev 51

¹¹⁹⁶C Ev 137-138

Director on the performance of the Chairman: the Senior Independent Director should meet the PRA and FCA each year to explain how the Senior Independent Director has satisfied himself or herself that the Chairman has held the CEO to account, encouraged meaningful challenge from other independent directors and maintained independence in leading the board.

Role of non-executive directors

718. Non-executive directors (NEDs) potentially have an important role in providing challenge to the executive of a bank. Many of the failures within banks that have come to light could have been prevented or ameliorated had NEDs acted more effectively.

719. The avenues open to them at present, however, are limited. They can make their point at board level, record dissent in the minutes, press their view to a formal vote, report their concerns to the regulator, or resign. None of these, except for insisting on and then winning a vote, may be effective, however, and all may ultimately degenerate into mere back-covering exercises.

720. Non-executive directors in systemically important financial institutions have a particular duty to take a more active role in challenging the risks that businesses are running and the ways that they are being managed. The FSA's report into the failure of RBS demonstrated that this was often not the case in the past. For non-executive directors to be more effective, they may need to make more use of their current powers under the UK Corporate Governance Code to obtain information and professional advice, both internally and externally. In this context, it is essential that the office of the chairman is well-resourced to enable it to provide independent research and support to the non-executive directors.

Internal controls and disciplines

The problem

721. The control framework of a bank, how it manages and assesses all of the risks it is responsible for, and how well it assesses its capacity to manage the future risk environment it may be facing, is crucial to the successful running of the organisation. Many banks told us that they used a control framework model called the “three lines of defence”.¹¹⁹⁷ The first line is front-line staff, who take responsibility for their own day-to-day risks. The second line is specialist risk management, controls and compliance staff. The third line is internal audit.¹¹⁹⁸ These are discussed further below. However, it is clear from the evidence we have received that this model, or at least the way the banks applied this model, was unable to prevent the multiple risk failures that occurred across the banking industry, from the collapses of HBOS and RBS to LIBOR, interest rate swaps mis-selling and PPI.

¹¹⁹⁷See, for example, DQq 177, 581, 3838

¹¹⁹⁸Ev 943

722. In Chapter 3 we described how banks were too big to fail and too complex to manage, and how bank control frameworks have tended to be characterised by confusion and a blurring of departmental responsibilities. Staff in compliance functions were often faced with seemingly impossible challenges, presenting a stark example of the problem discussed in Chapter 3 of banks being too complex to manage. For example, there are 3,500 compliance employees at HSBC who are expected to provide compliance services across a very complex organisational structure.¹¹⁹⁹ Stuart Gulliver described how he had felt the need to change the way the bank was organised due to these complexities:

So in January 2011, I changed the organisational structure of the firm—this is hugely fundamental—from being run by 88 separate country heads who reported to the group CEO to being run with 4 global business heads: commercial banking, global banking and markets, retail banking and wealth management and private banking; 10 global functions, which include: finance, legal, risk and compliance; plus our technology systems people.¹²⁰⁰

Regardless of a bank's size, evidence suggests that the compliance function was often faced with a multiplicity of tasks, from approving new product launches, to providing a legal-style advisory role on regulatory issues to providing assurance that the bank's systems and controls are working appropriately. Deutsche Bank told us, for example:

Deutsche Bank has an independent group-wide Compliance function. The role of the Compliance Department includes: advising on ethical conduct and identifying regulatory solutions; safeguarding integrity and reputation; and promoting, in partnership with the business, a culture of compliance.

As part of these general responsibilities, the role of Compliance includes the following core functions: Advice and training; Monitoring and surveillance; Risk assessments and reporting; Administering anti-money laundering and anti-corruption programmes; Initiating and carrying out investigations; Setting up and managing appropriate information barriers; [and] Engaging with regulators¹²⁰¹

723. Banks have a set of obligations that are externally imposed, through general law and specifically through regulatory requirements. These must be adhered to by everyone in the bank. In addition to the mandatory legal obligations, banks set their own control standards, relating to their overall business strategy, that they also need to ensure are being adhered to. The responsibility for making sure that there are no breaches of any of the internally or externally imposed requirements lies with all who work in the bank. The evidence suggests that the role of compliance is hopelessly confused. As also noted in Chapter 3, this was most starkly demonstrated in two exchanges with Barclays employees. Mike Walters, then Group Head of Compliance, told us that:

Mike Walters: it is not the compliance function's responsibility to make Barclays compliant. [...]

1199DQ 436

1200Q 3778

1201C Ev 88

Q679 Mark Garnier: Who was responsible for the compliance at Barclays—to make Barclays compliant?

Mike Walters: I believe that everybody at Barclays has the responsibility to do that.¹²⁰²

Hector Sants, Head of Compliance and Government and Regulatory Relations, told us that:

The first line of defence for conduct issues has to be the firms themselves and, in particular, it has to be the compliance function, which in general failed woefully in these firms. [...] A good compliance officer ensures that people in the firms do the right thing; it is not about them complying with the detail of the rules.¹²⁰³

In addition, risk and compliance functions have too often been treated as cursory box-ticking exercises to satisfy internal control or regulatory requirements, with limited practical impact on front-line activity. These problems can be exacerbated by the divide between the ‘police’ and the ‘policed’ within banks, where the highest status and rewards are afforded to those who raise most revenue for the bank.

724. We also noted in Chapter 3 the fact that in large, complex banks, it is very difficult for compliance functions to have a detailed understanding of the activities being undertaken outside their individual silo as minutely segmented by brutal crosshatching lines of management responsibility, functions, language and geographical location.

725. The Commission recognises that how a bank structures the framework it uses to control risks has to be shaped by its particular business model. However, the wide-spread failure requires a significant shake-up in internal controls. Our recommendations are based on the principles of ensuring personal responsibility and making internal challenge a norm, not an exception.

Front-line controls

726. Rich Ricci explained the control function performed by a front-line trading desk supervisor:

The supervisors’ responsibilities would include ensuring that the desk under his watch, and the people under his watch, are complying with all the relevant rules and regulations—also, with the standards of behaviour that the firm demands and aspires to. And he or she is the first line of defence in making sure that those standards are upheld. If there is a problem on the desk, we also then make sure that there are not issues from a supervisory perspective. If there are supervisory issues, we either discipline the supervisor as well or reinforce the education and learning the supervisor needs.¹²⁰⁴

¹²⁰² DQq 678-679

¹²⁰³ Q 2245

¹²⁰⁴ DQ 785

Barclays' then Group Head of Compliance acknowledged that this process failed in the case of LIBOR manipulation:

Mark Garnier: Who was overseeing the LIBOR rate-setters in London and why were they not answering back to these swaps traders in New York? Why were they not saying, "Guys, you can't do this; stop trying to influence the rate setting"?

Mike Walters: [...] we have desk supervisors in the first line whose job it is to ensure that we operate in a controlled way and that everybody knows the rules of the road and not just complies with our rulebooks and policies, but operates in accordance with our culture and values. So absolutely the first line is there to do that.¹²⁰⁵

The Chief Internal Audit Officer of Barclays told us that the bank had, in the light of the LIBOR investigation, initiated a "desk-level supervision enhancement programme [...] understanding what their roles and responsibilities are, training etc."¹²⁰⁶

727. As well as front-line controls, supervisors are also responsible for the financial performance of the trading desk and tend to be remunerated on this basis while risk management was not valued as a basis for remuneration. The Reward and Performance Director of Barclays explained that while the performance and, therefore, variable remuneration of retail bankers at his firm was determined by a formula incorporating non-financial measures, this was not suitable for investment banking:

In the investment bank, we do not codify the incentives structure in quite the same way. That is because the nature of the business and the activity being carried out is that much more varied, so codifying it in that quite clear way within the retail bank is fit for purpose and enables you to operate structured incentive programmes over a huge population of colleagues. It would be inappropriate to codify it in quite the same way over a much more complex and differentiated set of activities within the investment bank, but we do have a robust process within the investment bank to ensure that, for each business area and for individuals within those areas, we adopt the same sort of principles, where we are looking at both financial performance and the behaviour and how that financial performance has been achieved.¹²⁰⁷

Risk management

728. Reporting arrangements for Chief Risk Officers vary between banks. Santander UK told us that, in its structure, the CRO sat on the Board and the CRO's role "reinforces the executive risk responsibility of the Chief Risk Officer for the management and control of all risks".¹²⁰⁸ Barclays told us that "The Group CRO reports jointly to the CEO and the Chairman of the Board Risk Committee".¹²⁰⁹ In our examination of the collapse of HBOS, we found that the main reporting line of the divisional risk functions was to the divisional

1205DQ 668

1206*ibid.*

1207DQ 617

1208C Ev 18

1209C Ev 41

management rather than to the group risk function. Paul Moore believed that this created an ‘us and them’ culture between the group risk functions and the divisional risk functions, which was “dysfunctional”.¹²¹⁰

729. We note the evidence of Sir David Walker that “Certainly, the chief risk officer has to be able to say no to the chief executive. He has to be able to say no, without fear that he will lose his job or that he will not get an adequate bonus. He has to have a direct line to the chairman of the risk committee or the chairman of the board”.¹²¹¹ We concur. **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.**

Compliance

730. In Chapter 3, we noted the dangerous combination of blurring between the first and second lines of defence and a status gap between staff in specialist control functions and those in front-line revenue-raising roles. These problems were widespread and reinforced, rather than challenged, by management expectation. Evidence from several banks pointed to ongoing concerns of this nature in the product approvals process. Citigroup told us that the compliance function plays “an integral part of the new product and new business line approval process”.¹²¹² This appears to place compliance in a first line risk management position, when in most cases banks described the function as sitting in the second line of defence. The then Head of Compliance at Barclays outlined a similar arrangement at his bank:

Mark Garnier: Can you talk us through the process of how a new product is constructed, at what point you get involved and at what point it then gets rolled out to market?

Mike Walters: Our key involvement is at the new product approval stage. However, at an earlier stage it is possible that we would get asked for subject matter expert guidance on a rule.

Mark Garnier: The key question—they are coming to you for expert advice. The product design departments do not have their own experts on compliance.

1210BQ 7

1211Q 32

1212C Ev 64

Mike Walters: No, that's not right. The reason why I said it was possible is that every banker I've met at Barclays has a pretty good understanding of the rules [...] That said, it is possible from time to time that specific expertise on a specific area of the regulations is sought.

Mark Garnier: When you have new product approval, you are then brought in in a formal way, and at that point you give the sign-off?

Mike Walters: Yes.

Mark Garnier: So you then take responsibility for the compliance side of that.

Mike Walters: For the compliance aspect, yes.¹²¹³

Mike Walters also told us that “complying is the responsibility of everybody at Barclays, starting with the front line”.¹²¹⁴ The acting Group Head of Compliance at HSBC explained that his staff had a dual role:

David Shaw: You could have it in a different way, where the business decides on the product, goes through the whole process and submits it up for approval. You could have that, but it is not a very constructive way of dealing with it.

Mark Garnier: Why not?

David Shaw: Because basically it is a lot better if the input, “This does not work,” comes in during the formulation.

Mark Garnier: Why? I can see the argument, but we are trying to gather evidence, so what we are really after is clear explanations of those two processes. Why is one better than the other?

Marc Moses: One of the mantras in risk and compliance is that we are there to enable and protect. The protect bit is where we say no, and the enable bit is to work in partnership with the business to come to the right answer given our risk appetite, given our values and given our reputation.¹²¹⁵

731. The CBI told us that “compliance needs to become more independent to avoid conflicts of interest that may arise through an employee's desire to satisfy senior colleagues rather than raise compliance issues”.¹²¹⁶ Mike Walters, explained that LIBOR manipulation in his bank was the result of cultural failure rather than of control frameworks:

Mark Garnier: How did those LIBOR setters not [know] what was going wrong? [...] Why did those rate setters not turn round and say, “You can't do this; we have to be independent”? [...] How did you, as head of compliance, allow them to be influenced?

1213Qq 654-7

1214DQ 674

1215Qq 460-2

1216Ev 916

Mike Walters: I do not accept that compliance allowed them to be influenced. We train out our policies and our rules of the road. People are trained to deal with conflicts of interest and to do the right thing. Clearly, in this case, there was a breakdown of not just our compliance with procedures but, more fundamentally, a culture. The culture of doing the right thing clearly broke down in that case.¹²¹⁷

732. Rich Ricci said that in certain circumstances, compliance rather than front-line staff might be blamed if a bad deal was signed off at a trading desk:

the buck stops with the business and I think they expect to feel the heat on the deal. I want to be clear, but obviously there are circumstances where if the advice they got was wrong or if there was an issue with the second line of defence in the execution of the deal, that may be different.¹²¹⁸

733. We also examined the interaction between staff in the front line and those in the second line of defence in performance assessment. Several witnesses told us that employees in the second line now contribute to performance assessment for those in revenue-raising roles. Mike Rees of Standard Chartered noted that there is “input from the control functions, compliance and risk” in front-line performance evaluation.¹²¹⁹ His colleague, Richard Goulding, elaborated:

The risk function is very directly involved in all individual compensation awards, so for example I have, for my full six years as chief risk officer, chaired our global markets bonus plan allocation committee. We formally have all risk and control internal order reports submitted to that committee so that we can ensure that accountability is taken of that in people's performance ratings and then the decisions that are taken on awards off the back of that. We have an automated system where the people in the risk and control and compliance functions are invited to comment on the behaviour of individual people in the front office which is then also brought out of that committee and used to inform decisions.¹²²⁰

Eddie Ahmed told us that, at Citigroup, the performance assessment of senior staff would include input from risk and compliance functions. However, at trading desk level, assessment would be “in the chain of command, and ultimately signed off by the business head, in conjunction with assessment by human resources”.¹²²¹

734. Michael Lavelle, CEO of Wholesale Banking at CitiGroup, explained that staff in front-line functions could be involved in assessing those in the second line, as well as the other way round:

Baroness Kramer: And how would each feed into the other's appraisal? Would your risk person have an impact on what the pay levels might be—

1217DQ 673

1218DQ 773

1219DQ 139

1220*ibid.*

1221DQ 298

Michael Lavelle: In the assessment, absolutely.

Baroness Kramer: What about the other direction?

Michael Lavelle: If it was specifically requested, of course. We would expect our professionals to be assessed by risk. It is not absolutely necessary that risk professionals be assessed by people in the business. More often than not, they would ask for that to happen, of course. You can provide both formal feedback on individuals and informal feedback, depending on the role.¹²²²

735. 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.

736. 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.

737. 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

738. The Group Head of Internal Audit at HSBC acknowledged that the work of his division had been characterised by a rules-based approach:

Baroness Kramer: In a sense, you were not looking at judgement; you were only looking as to whether people had taken the procedural step. Is that what you are saying?

Paul Lawrence: I think that is a fair comment. It is actually very difficult for an audit unit, based on the skill sets it had and where it traditionally was in the organisation, to pass an opinion on judgements or issues of strategy. I think your observation is correct, but we are in a better place now.¹²²³

739. Roger Marshall explained how he saw the relationship of internal audit with the other parts of the business:

“That is the risk I was talking about. In a well run organisation, the first line has to say, ‘We are responsible for all our decisions.’ The second line, particularly risk management, are there to make sure that the first line are keeping to their limits, basically. The blurring comes when the first line wants to do something which is outside their normal limits and the second line gets involved in agreeing that; then, suddenly, the second line are part of the decision-making process, not outside it. That is why it is particularly important that internal audit looks at those sorts of thing, completely independently”.¹²²⁴

This “complete independence” as Roger Marshall described it, reinforces again the need for this function to be protected by the non-executives to ensure their own independent challenge is informed by analysis that is also independent of the executive. Roger Marshall went on to describe a broad remit for internal audit “Internal audit should—and, by and large does, in UK banking—have an unrestricted remit. It should look at governance, it should look at culture, it should look at the way that the risk management departments manage risk, and it should look at compliance and how they are doing things.”¹²²⁵

740. Anthony Hilton said that “Internal audit is a way for top management, whatever it is—the risk committee or the audit committee—effectively to circumvent several layers of middle management and find out what is happening on the shop floor”.¹²²⁶ The Head of Internal Audit at Standard Chartered Bank confirmed that the breadth of scope:

Baroness Kramer: So how broad would your scope be, Mr Wynter? Would it include product suitability, HR policies for recruitment, business strategy or perception? How wide-ranging is it?

Julian Wynter: It is everything, really. We have unrestricted access to all of the bank's activities and all of the information.”¹²²⁷

The CBI said that internal audit should not be restricted to historic analysis, but elevated to a role in decision-making processes.¹²²⁸

741. 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

1223 DQ 408

1224DQ 46

1225DQ 54

1226DQ 71

1227DQ 196

1228Ev 916

the audit committee. Dismissal or sanctions against the head of internal audit should also require the agreement of the non-executive directors.

Conclusion on internal controls

742. 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

Introduction

743. Our witnesses were united in agreement that a change in banking culture was necessary. Antonio Horta-Osório said that the banking industry was facing a “deep crisis of confidence and trust” and “needed cultural change”.¹²²⁹ Stephen Hester agreed that “there are cultural changes that we should make across banking”,¹²³⁰ while Antony Jenkins told us that it was necessary to “change the culture” at Barclays.¹²³¹ The Chartered Banker Institute said that “extensive cultural change” was required in banking.¹²³² The CBI submitted that such change was “key to ensuring banking can support business’ needs”,¹²³³ while the ABI said it was “the key to further change in banks”.¹²³⁴

744. In this section, we argue that standalone programmes of cultural change, however well-intentioned, are unlikely to succeed. Worthy statements of direction or a reshuffling of faces at the top may change the outward image of an organisation. However, if they leave the underlying causes of cultural malaise intact, they are ultimately doomed to failure.

Prospects for rapid change

745. In our first oral evidence session, Sir David Walker, the then prospective Chairman of Barclays, was bullish about the prospects of achieving quick cultural change in his company:

1229 “Lloyds looks beyond PPI and LIBOR”, *The Financial Times*, 26 July 2012, www.ft.com

1230Q 880

1231Q 3560

1232Ev 932

1233Ev 914

1234Ev 743

Can all that be done, and quickly? My answer is a resounding affirmative. If I may say so, if I didn't have confidence about that, I think I would have been very unwise to take on the role I have in one of the major banks.¹²³⁵

He explained that the crisis in UK banking offered an opportunity for unusually rapid cultural change:

Cultural changes can tend to happen over a long period of time. However, in the present environment, there is an important question about reparability. Can the present cultural changes be accomplished rapidly? My pretty confident answer is, "Yes, and of course they have to be."¹²³⁶

746. The Salz Review of Barclays was less confident that cultural change could be achieved quickly:

Transforming the culture will require a new sense of purpose beyond the need to perform financially. It will require establishing shared values, supported by a code of conduct, that create a foundation for improving behaviours while accommodating the particular characteristics of the bank's different businesses. It will require a public commitment, with clear milestones and regular reporting on progress. It will require Barclays to listen to stakeholders, serve its customers and clients well get on with the work to implement its plans and stay out of trouble. The complexity of Barclays' businesses makes this a particular challenge for its leaders. It will take time before it is clear that sustainable change is being achieved.¹²³⁷

Others respondents took a similar viewpoint. António Horta-Osório cautioned that "changing the culture of an organisation of 100,000 people takes time",¹²³⁸ while RBS wrote that enduring change would be "the product of a slow, deliberate and sustained march with many small steps".¹²³⁹

747. In his second appearance before the Commission, Sir David Walker reiterated his confidence that the culture of Barclays could be changed quickly.¹²⁴⁰ However, he suggested that progress in the short-term would be restricted to highlighting the need for change and putting appropriate frameworks in place:

there are two dimensions: there is what we need to do immediately, which is to talk about it and to put in place the programme of work that has been described, then there is embedding something for the long term. We have to have a short-term as well as a long-term agenda.¹²⁴¹

1235Q 17

1236*Ibid.*

1237Salz review: *An independent Review of Barclays' Business Practices*, April 2013, para 2.20

1238Q 3474

1239Ev 1324

1240Q 3666

1241Qq 3666-7

748. **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.**

Bank codes of conduct

749. The primary vehicle the new Chairman and Chief Executive of Barclays have used to try to effect rapid cultural change in Barclays is the “Transform Programme”.¹²⁴² A prominent element of this is the adoption of a Statement of Purpose and Values. This was explained in the bank’s response to the Salz Review:

Barclays’ Purpose (Helping people achieve their ambitions – in the right way) and Values (Respect, Integrity, Service, Excellence and Stewardship) are standards which will guide our decision-making and against which all employees will be assessed and rewarded. We believe that building a sustainable, values-based culture will form the foundation of our long-term success.¹²⁴³

750. In evidence to the Commission, Antony Jenkins explained that Barclays had not previously had “a set of values and behaviours that are operative across the whole Group” which defined “what the Barclays culture should be”.¹²⁴⁴ However, the then Chief Executive, John Varley, attempted to establish five similar Group-wide values in 2005: ‘customer focus’, ‘winning together’, ‘best people’, ‘pioneering’ and ‘trusted’. This was intended to allow the Group to be overseen through one set of values. In 2007 they were embedded in a refreshed Group Statement on Corporate Conduct and Ethics.¹²⁴⁵ Writing in *The Financial Times*, Philip Augar remarked:

[...] as Barclays’ recent history shows, the problem with values statements is making them stick. For, even as some employees were fiddling the London interbank offered rate and selling customers interest rate swaps and unnecessary payment protection insurance, the bank already had an apparently robust code of conduct.¹²⁴⁶

The Salz Review observed that the five Guiding Principles had not “percolated into the consciousness of the Group”,¹²⁴⁷ partly because of the “significant challenge to instilling shared values in a universal bank like Barclays”.¹²⁴⁸

751. Statements of values and corporate codes are not restricted to Barclays. The word cloud below shows the distribution of words used by a selection of banks in their corporate statements:¹²⁴⁹

1242 “Becoming the ‘Go-To’ bank”, *Barclays*, 2013, www.group.barclays.com

1243 *Barclays, Barclays’ response to the Salz Review*, 25 April 2013, p 5, www.group.barclays.com

1244 Q 3542

1245 *Salz review: An independent Review of Barclays’ Business Practices*, April 2013, para 8.14

1246 “The cost of making bankers behave”, *The Financial Times*, 28 January 2013, www.ft.com

1247 *Salz review: An independent Review of Barclays’ Business Practices*, April 2013, para 8.17

1248 *Ibid.*, para 8.16

Excellence: We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.¹²⁵²

752. Which? wrote that many of the most egregious conduct failings “involved banks where the top management appeared to have set explicit and impeccable cultural standards for employees”.¹²⁵³ The 2009 Goldman Sachs Code of Business Conduct and Ethics championed “integrity and honesty” as being “at the heart of our business”, but contained a caveat that “from time to time, the firm may waive certain provisions of this Code”.¹²⁵⁴ Others claimed that cultural codes were not taken seriously. The Chartered Institute for Securities & Investment (CISI) said that “it is one thing to have a code and quite another to monitor and measure the extent to which any person follows it with a professional pride that goes beyond cursory compliance”.¹²⁵⁵ Ken Costa told us that “mission statements and all the various statements that are made are very often merely bolt-ons”.¹²⁵⁶

753. Several witnesses told us of the importance of the ways in which corporate values were embedded throughout an organisation. CFA UK wrote that “it appears that some banks have paid lip service to professional standards and culture within their marketing communications, but have not embedded those ideals and behaviours within their firms. Anthony Browne said that codes “do not mean anything if they are just bits of paper that people tick. [...] they need to be embedded within organisations”.¹²⁵⁷ RBS told the Commission that:

We believe that the delivery of real cultural change is more likely to be a consequence of having created a good company that serves its customers well than of having implemented a standalone programme of cultural change.¹²⁵⁸

Sir David Walker told us:

there needs to be a clear statement of values. Most banks actually have them, but the problem is not with the values but how they are embedded from top to bottom.

The means of embedding change are considered in the following sections.

754. 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

1252Enron, *Annual Report 2000*, p53

1253Ev 1456

1254William D. Cohen, *Money and Power: How Goldman Sachs Came to Rule the World*, (UK, 2012)

1255Ev 938

1256Q 2732

1257Qq 2488-90

1258Ev 1321; see also Ev 890, 1367

problems of standards and culture. But they should not be confused with solutions to those problems.

Tone at the top, middle and bottom

755. The phrase “tone at the top”, or “tone from the top” rose to prominence in the aftermath of the Barclays LIBOR settlement in 2012. The regulator, the FSA, had become concerned at the aggressive pattern of behaviour of Barclays towards regulatory issues. This was of sufficient importance that the then head of its Prudential Business Unit, Andrew Bailey, went to the Barclays board in person to express the FSA’s concerns about the firm, and the Chairman of the FSA, Lord Turner, subsequently wrote to the Chairman of Barclays, Marcus Agius. Andrew Bailey told the Treasury Committee that he had said to the board that the tone at the top was of concern to the FSA, and also told the Committee that “the culture of this organisation was coming from the top”.¹²⁵⁹

756. The importance of setting the appropriate tone from the top of banks in attempting to improve culture was highlighted by a large number of respondents. The FSA said that the standards, culture and values of banks depended on “the tone set by top management”.¹²⁶⁰ Lloyds Banking Group wrote “the tone and example needs to come from the top—having leaders with the highest integrity and values, who think and act for the long-term”.¹²⁶¹ The Institute of Operational Risk, arguing that “codes of conduct alone are not sufficient to change risk cultures”, said that senior management needed to set the example by exhibiting “integrity, fitness, propriety and suitability for their roles”.¹²⁶² The FSA Financial Services Consumer Panel stressed the role of the personality of leaders in driving cultural change:

“tone from the top” is extremely important within any organisation. This is because culture inevitably reflects the ethos or philosophy of the leader to a degree. Hence, the character of leadership is particularly important in ensuring good cultural values are permeated throughout financial services firms.¹²⁶³

757. The ABI said that the Commission would be most effective if we focused on “changes of culture that are already underway, and on encouraging those who are trying to lead this”.¹²⁶⁴ Ken Costa said that though the need for a cultural shift was starting to be recognised among bank leaders, this was yet to be understood at lower levels:

I think the penny is beginning to drop; I don’t think it has dropped lower down. We are still at the process where, even at senior levels, we are trying to grasp just the magnitude of what has gone on, and how it is that one can reposition the culture of a bank for the next phase of learning the lessons of what went wrong.¹²⁶⁵

¹²⁵⁹Treasury Committee, Second Report of Session 2012–13, *Fixing LIBOR: some preliminary findings*, HC 481-I, pp 59–83

¹²⁶⁰Ev 1042

¹²⁶¹Ev 1216

¹²⁶²Ev 1136

¹²⁶³Ev 1037

¹²⁶⁴Ev 743

¹²⁶⁵Q 2729

758. In a recent speech, the incoming Governor of the Bank of England, Dr Mark Carney, argued that to change the culture of banks, tone from the top needed to be supplemented by an appropriate sense of purpose throughout firms:

For companies, this responsibility begins with their boards and senior management. They need to define clearly the purpose of their organisations and promote a culture of ethical business throughout them.

But a top-down approach is insufficient. Employees need a sense of broader purpose, grounded in strong connections to their clients and their communities. To move to a world that once again values the future, bankers need to see themselves as custodians of their institutions, improving them before passing them along to their successors.¹²⁶⁶

Simon Thompson made a similar point, suggesting that while the role of senior management in culture was “absolutely key”, “tone at the middle and the tone at the bottom” were also important as “you need to have individuals surrounded by a culture of professionalism”.¹²⁶⁷

759. Dr Adam Posen warned against the assumption “that if banks simply sign up enough compliance officers, that constitutes a change of culture, rather than constitutes a tax that they are paying to make sure that they are not legally liable.”¹²⁶⁸ Professors Black and Kershaw argued that cultural change had “to be “mainstreamed” throughout the organisation, not siloed off into “compliance” or “risk” divisions”.¹²⁶⁹

760. The CBI told us that, to achieve cultural change, “systems and procedures within firms must drive values throughout the organisation” and “individuals need to understand the behaviours expected of them and be held accountable for their actions”.¹²⁷⁰ These sentiments were reflected by Antony Jenkins in his explanation of how he intended to embed cultural change in Barclays:

we have trained over 1,000 values leaders from all different parts of the organisation and all different levels to go out across Barclays and explain to their colleagues how these things are going to work. We have created a training programme for all our senior leaders so that they will be better equipped to operate the system. The most senior people in the organisation—the top 150—will have a different training programme, which will allow them to enable this. So it is a total system to change the culture at Barclays. It has many elements, but they all come together to set a different standard in the organisation, to be able to identify when people are delivering against that standard and to deploy the appropriate consequences, positive or negative.¹²⁷¹

¹²⁶⁶Bank of Canada, *Rebuilding Trust in Global Banking speech*, Mark Carney, 25 February 2013, www.bankofcanada.ca

¹²⁶⁷Q 2437

¹²⁶⁸Q 2698

¹²⁶⁹Ev 833

¹²⁷⁰Ev 914

¹²⁷¹Q 3557

761. Professor Nicholas Dorn stressed the importance of incentives in driving cultural change throughout bank staff hierarchies:

While attention has been drawn to “the tone at the top”, “the tone in the middle” and “the tone at the bottom” are as important. Collectively, mid- and lower-level staff see and know more than chief executives or boards. To reform culture, all levels need to be properly incentivised.¹²⁷²

The role of these incentives is considered in the next section.

762. 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.

763. 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.

Individual incentives for improvements to standards and culture

764. Dr Adam Posen argued that the culture of banks reflected the accumulated consequences of a wide range of economic incentives:

I tend to believe that a lot of what we call culture does respond—at least in commercial areas—to incentives. Part of the issue is that when capital is impeded at these banks, when these banks have compensation schemes that reward deal-making and international deal-making over high street lending, and when they have short-term objectives and compensation schemes that emphasise short-term trading, those things produce a certain culture. The swaggering, macho, somewhat nasty fraudulent culture that emerges reinforces it.¹²⁷³

765. Martin Taylor told us that codes of conduct were unlikely to succeed in improving standards if financial incentive worked in the opposite direction:

1272Ev 983

1273Q 2698

Simply introducing a code of conduct and making everybody sign it would be the wrong way round. [...] It cannot be done [...] by propaganda and PR. It must be deeply grounded and deeply grounded in behaviours. You cannot tell people to operate to professional standards on Monday and then, on Tuesday, give them the kind of sales target that requires them not to operate to such standards.¹²⁷⁴

Professor David Kershaw also argued that incentives tended to trump other considerations:

If the focus is upon cultural change and generating more ethical culture in banks, we think there are some things you can do, but you need to start with the basic incentives, because the basic incentives of senior managers and directors, and therefore of lower-level employees, are at odds with the sorts of cultural objectives you want to achieve, and you are not going to effect cultural change, no matter how strong your sanctions, no matter how well resourced the regulator is; it is just not going to happen.¹²⁷⁵

Which? concurred that in order to embed genuine change, staff needed to be “given the proper incentives to maintain high levels of professional standards.”¹²⁷⁶

766. Commenting on their internal reform programme, RBS argued that specific programmes aimed at rapid cultural change were unlikely to be successful while wider frameworks remained untouched:

While we consider these measures to be important, we have no illusions about their ability to effect instant cultural change. We fully anticipate that it will take years to follow through on this programme and that the effects may not be immediately visible. Moreover, we believe that the delivery of real cultural change is more likely to be a consequence of having created a good company that serves its customers well than of having implemented a programme of cultural change.¹²⁷⁷

767. Media coverage of Antony Jenkins’ announcement of the new Barclays Statement of Purpose and Values suggests that it was met with, at best, mixed feelings among the traders in his company.¹²⁷⁸

768. 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.

1274Q 416

1275Q 2686

1276Ev 1445

1277Ev 1321

1278See, for example, “Antony Jenkins to staff: adopt new values or leave Barclays”, *Daily Telegraph*, 17 January 2013, www.telegraph.co.uk and “City Life: Traders mock as Barclays’ new boss tries out Jerry Maguire-style gamble”, *Evening Standard*, 18 January 2013, www.standard.co.uk

769. There is still much to do in promoting diversity within banks. There is a need to hold banks' feet to the fire in encouraging the gender diversity of their workforce. **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.**

Indicators of changed culture

770. **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

Introduction

771. The banking scandals which we have examined occurred even though the institutions concerned had formal internal compliance and control structures which ought to have prevented wrongdoing. But these systems failed to function effectively. For example, in HSBC, despite repeated internal and external warnings, failings in anti-money laundering systems that made the bank “very attractive to transnational criminal organisations, whether they are terrorist or criminal in origin,” were allowed to persist.¹²⁷⁹ In Barclays, UBS and RBS, the manipulation of LIBOR submissions for individual profit continued unrestrained for years, without internal compliance preventing it.

772. As well as this failure of formal control systems, the firms concerned were also apparently not tipped off about wrongdoing by their own employees. Had this occurred, the firms might have been able to shut down the wrongdoing much earlier and prevent much of the penalties and reputational damage they incurred. Why did this not happen? Huw Jenkins, former CEO of UBS investment bank, acknowledged that this clearly demonstrated “a failing in our systems and controls and in our culture.”¹²⁸⁰

1279Q 3778

1280Q 2038

Reasons the banks were not told by their own employees

773. A number of different reasons have been given to us. The common factor is that employees feared the consequences of speaking out.

Fear in banking culture

774. An internal investigation into Barclays Wealth America found that it had a “culture of fear” that was “actively hostile to compliance” and “ruled with an iron fist to remove any intervention from those who speak up in opposition”. Issues with the “revenue at all costs strategy” were not escalated up the management chain, but “buried, stopping any solution ever coming to light”.¹²⁸¹ A whistleblower writing in *The Independent* claimed that the Barclays investment bank was run “through a culture of fear. You fear for your job and you fear for your bonus”.¹²⁸² The Salz Review reported that similar problems remain:

There is also evidence from Barclays’ internal Employee Opinion Survey of a cultural unwillingness to escalate issues. A significant proportion of employees in the investment bank, for example, said that they were “reluctant to report problems to management”, and that they did not feel able to “report unethical behaviour without fear of reprisal”. This is not isolated to the investment bank—as our own staff survey showed.¹²⁸³

The same charge has been made of the culture of RBS during Fred Goodwin’s tenure as Chief Executive:

the former chief executive’s “aggressive, macho management style” [...] created a culture where staff were locked in constant fear of losing their jobs, and his lieutenants were said to have stopped employees speaking out about problems.¹²⁸⁴

In addition, the way in which banks suddenly dismiss employees, without colleagues being told, can deter employees from raising concerns:

[...] the callousness with which people are laid off, and the code of silence that immediately surrounds this person, means that if, say, you have noticed wrongdoing or a risk and you want to take that up, you know that there is the regular culling of the herd. You know that there are alliances that you may have struck up with colleagues who have promised to stand with you, but they may be gone the next day, for a completely unrelated reason.¹²⁸⁵

775. These concerns are not unique to banking. A recent review of the BBC, found “a strong undercurrent of fear”. It observed that many freelancers felt that “getting a

1281 Genesis Ventures report into Barclays Wealth, cited in “Exposed: The regime of fear inside Barclays - and how the boss lied and shredded the evidence”, *Mail on Sunday*, 20 January 2013, www.dailymail.co.uk

1282 “Whistleblower: ‘The culture ultimately comes from the top’”, *The Independent*, 7 July 2012, www.independent.co.uk

1283 Salz review: *An independent Review of Barclays’ Business Practices*, April 2013, para 12.41

1284 “RBS collapse down to Fred Goodwin’s ‘culture of fear’”, *The Scotsman*, 22 June 2012, www.scotsman.com, 22 June 2012, reporting on Ron Kerr and Sarah Robinson’s analysis, “From Symbolic Violence to Economic Violence: The Globalizing of the Scottish Banking Elite”, *Organization Studies*, vol 33, issue 2 (2012), pp 247-266

reputation for speaking out or as a troublemaker is considered by many to be one form of ‘career suicide’.¹²⁸⁶ The Francis Report on Mid-Staffordshire NHS Trust found that “It is clear that there is a very real reluctance on the part of staff at all levels of seniority to persist in raising concerns about unsafe or substandard services, colleagues’ capability and conduct, and similarly important issues. There is a widespread belief that the protections offered are theoretical rather than real.”¹²⁸⁷

776. These fears may be justified: employees who express concerns about questionable practices in a bank may suffer as a result. In the worst cases, individuals who expressed concern may have been moved on.

Fear from sales pressures

777. We heard evidence from Citizen’s Advice and Which? about the pressures staff felt under to sell products:

Q47 Mr McFadden: Were the kind of front line sales service staff that I am talking about given specific targets per month or per week for the number of PPI products that they had to sell?

Sue Edwards: When we did our super-complaint, we talked to Amicus—now Unite—about whether they had any evidence of their bank staff being put under pressure to sell PPI. They said they did not have any specific evidence about PPI, but they were dealing with a lot of cases of members who were put under pressure to sell a very high number of products, which they could not achieve and were facing disciplinary action as a result.

Peter Vicary-Smith: I think we circulated this to the Committee. Certainly if we have not, we can do so. We did research recently among 500 bank staff to see whether things have changed. In that, we found—this is bank staff reporting to us privately about the pressure to sell—that I think 83 per cent said that they felt under the same or greater pressure to sell, and 40 per cent of bank staff were saying that they knew a colleague who had mis-sold in order to meet a sales target. It goes on through, and that is true throughout the industry. That says to me that there are some great changes being made by some institutions—we talked before about Barclays and Co-op having made significant changes to the remuneration structure to remove incentivisation from front-line sales—but the culture needs to change. It is not just the structure of remuneration; it is what you feel pressured to do. That needs to change as well if it is going to impact on consumers.¹²⁸⁸

Stuart Davies, regional officer of Unite, told us that:

The treatment of our members on a day-to-day basis within the banks feeds into the treatment of customers on a day-to-day basis. Our concern sits around a very, very

1286BBC, *Respect at Work Review*, 2 May 2013, pp 19-21, www.bbc.co.uk

1287The Mid Staffordshire NHS Foundation Trust Inquiry, *Independent inquiry into care provided by the Mid-Staffordshire NHS Foundation trust January 2005–March 2009*, HC 375, p 409

aggressive sales culture that sits in the banks and a very aggressive performance-management culture that exists in the banks, to the extent of e-mail trails that go round and round individual performance on performance targets and whiteboards that contain information on individual performance. That feeds into increased pressure on staff, which feeds into, perhaps, some dysfunctional selling to customers, because they are concerned for their jobs.¹²⁸⁹

Fear of damage to reputation and career

778. Employees in the financial services industry, because of its particular characteristics, may fear for their employability and reputation if they complain about wrongdoing of all sorts:

It is certainly the case that if you blow the whistle, it is not only about risk taking or rogue trading and that sort of thing, but sexual harassment. I have spoken to a lot of women who have been through incidents of sexual harassment who did not report it. All of them would say, “My career in finance in general would be over.” Even though it is so large—250,000 people—there are all these little niches. Usually your competence stretches to that niche plus a few adjacent niches. If you step out of the family and you report somebody and you blow the whistle, basically you step out of the code of the entire sector. That has stopped these women reporting things that were truly shocking.¹²⁹⁰

Encouraging escalation and whistleblowing

779. Fear of the consequences, even if misplaced, deters bank employees from raising wrongdoing with their manager or firm. The numbers of successful whistleblowers in banks is understood to be very low. This is not in the interest of banks themselves. The people best placed to flag up emerging failings in culture and standards are a bank’s own employees. Despite the widespread knowledge of LIBOR-rigging on the trading floor, no employee apparently felt sufficiently concerned, or sufficiently confident, to ‘whistleblow’ by escalating the problem internally, or informing the regulator. As we have said, had staff come forward at an early stage, even at one firm, and had their concerns been acted on with appropriate reporting to the regulator, much of the damage caused by the LIBOR-rigging scandal might have been avoided.

780. Dr Andrew Hilton of the CSFI described the positive impact that whistleblowers could have, saying that an effective internal whistleblowing system:

can actually operate rather like an internal audit function and can be genuinely, extraordinarily useful to the companies, because it enables the top management to circumvent all sorts of problems in the middle management and get down to what is really happening at the rock face.¹²⁹¹

1289JQ 276

1290DQ 105

1291DQ 52

781. Rich Ricci of Barclays showed a marked appreciation of the scale of what went wrong. He admitted that the bank’s culture may have been an impediment to effective internal whistleblowing:

You want an environment where people feel safe [...] we were a culture that did not like people who admired problems; we liked people who drove solutions. I think that shift may have been too much. People have to be encouraged to raise problems, and not to be afraid to say, “This is an issue,” without having a solution, so that everyone can fix it. That is a learning that we in the investment bank need to reinforce.¹²⁹²

The ICAEW told us that:

In addition to personal integrity, and the correct tone from the top, there is a need for an organisational structure that encourages and rewards people for acting with integrity, and which seeks to avoid creating conflicts among staff.¹²⁹³

Ali Parsa, Chief Executive, Circle Partnership, said that:

Our organisations are still stuck in the era of, “What processes can I put in place in order to manage you to do your job?” We need to think about what values to put in place, and what values do I judge you by and trust you to get on and do it? You then create an environment in which you self-regulate and self-police each other to make sure you stick to that set of values.¹²⁹⁴

Whistleblower Martin Woods commented that “Ultimately it is all about culture [...] a culture which encourages people to speak out and rewards them for doing so.”¹²⁹⁵

782. Whistleblowing in the financial services sector needs to be treated by firms not as inconvenient and potentially damaging, but as a valuable source of information for senior management. We set out below some of the practical steps that we expect banks to take to provide greater encouragement and protection for internal whistleblowers. Procedural and practical solutions will only be effective if they are underpinned by a significant change in bank standards and culture.

Banks’ own whistleblowing policies

783. Whistleblowing policies and procedures do exist within banks, but they failed. In evidence they were criticised for being insufficiently clear, well-publicised, and robust. Whistleblowing charity Public Concern at Work commented that:

Many policies are too legalistic, complicated, fail to give options outside line management, do not provide adequate (or any) assurances to the individual, place

1292DQ 792

1293Ev 1131

1294DQ 8

1295Ev 1633

the duty of fidelity above all else, and contain contradictory and/ or poor reassurances on confidentiality.¹²⁹⁶

In oral evidence to us, HSBC told us that it rewarded staff who drew attention to wrong behaviour of different kinds, but struggled to demonstrate how its internal guidance documents clearly set out the expectation for staff to escalate matters if they became aware of wrongdoing.¹²⁹⁷ Professor Nicholas Dorn told us that:

A significant (quite high) level of clawback would be appropriate for those working alongside or near the locus of undesirable behaviour. In the absence of such an incentive, nearby staff might possibly disapprove of the behaviour but shrug it off (on the basis that it is not really their business, since they themselves are not directly involved and hence would not be held to account); or they might observe the behaviour with some amusement or excitement (“so that’s how it works!”); or they might even facilitate it in small ways (carrying out tasks on request).¹²⁹⁸

784. 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.

785. Concerns reported by employees may be less specific than those typically associated with whistleblowing. Employees may feel a sense of unease about a practice or a product without necessarily understanding or anticipating the scale of the problem. Stuart Davis, from Unite Union, told us that bank staff had concerns about PPI long before it emerged as a scandal: “Clearly, there was growing discomfort among our members that perhaps the products they were selling were not all they were cracked up to be”.¹²⁹⁹ We noted earlier in this chapter the enormous pressure front-line staff were under to sell products, not just as a result of financial incentive structures, but also as a result of less formal cultural influences. Jayne-Anne Gadhia, now CEO of Virgin Money, told us of her struggle with her previous employer to get them to address problems relating to PPI:

I used to work at RBS until about seven years ago, and at the time I was working in an area that was selling PPI. I spoke to a senior person at RBS about the need to withdraw PPI at that time from our - from RBS’s- marketing, and the reply I got was, “Yes, it is clear that that should be withdrawn but we can’t be the first people to do it because we would be the ones who lose profit first.”¹³⁰⁰

786. In addition to procedures for formal whistleblowing, banks must have in place mechanisms for employees to raise concerns when they feel discomfort about products

1296Ev 1300

1297DQq 549-53

1298Ev 984

1299 JQ 279

1300FQ 37

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.

Senior responsibility

787. If whistleblowers are to have the confidence to come forward within firms, they need to be reassured that their reports will be dealt with appropriately and that they will be protected from detrimental treatment by their employer. Professor Nicholas Dorn said that:

It is clear that positive whistleblowing policies must be a key element in establishing the right tone and culture throughout an organisation. Internal audit plays a central role in this, eg as a first point of contact for whistleblowers, as an instrument to deal with information given by whistleblowers to the board, its chair, or its audit committee, or as a whistleblower itself. It is not clear whether the whistleblowing arrangements themselves were inadequate in the run-up to the financial crisis or whether warning voices were drowned out because the prevailing culture, led from the top, did not support questioning the overall risk strategy.¹³⁰¹

788. Internal whistleblowing processes must be overseen by an individual with the authority and seniority both to ensure that whistleblowing reports are acted upon and to protect the whistleblower. **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.**

What firms’ whistleblowing regimes should contain

789. We do not propose a one-size-fits-all approach to establishing appropriate whistleblowing procedures. There already exists a wealth of best practice guidance and, as we have already made clear, the success of a whistleblowing regime will owe more to an institution’s overall culture than the minutiae of its procedures. Nonetheless, we believe that there are some elements of a successful whistleblowing policy which are sufficiently important that they should be incorporated into every institution’s whistleblowing processes, and we outline these below. Beyond this, it is for the Chairman or other responsible board member to ensure that the whistleblowing procedure at the firm is fit for purpose, as outlined above.

Protection

790. In many cases whistleblowers will act anonymously, but where whistleblowers are not anonymous they need particular protection, because a key barrier to effective whistleblowing is the fear that staff will face repercussions from their employer for having drawn attention to wrongdoing. We note that legal protection for whistleblowers does already exist in the form of the Public Interest Disclosure Act 1998 (PIDA). A person making a “protected disclosure” which falls within the terms of PIDA (including an allegation of criminality or failure to comply with a legal obligation) and who is subsequently detrimentally treated by his or her employer can take their case to an employment tribunal and seek damages. But in spite of this legal protection, blowing the whistle remains daunting. Martin Woods commented that “when an individual blows the whistle in a bank, he/she is blowing the whistle against some very powerful and very strong people.”¹³⁰² Ian Taplin described the pressure not to whistleblow as “immense” and argued that whistleblowers within the banking sector can face intimidation and obstruction.¹³⁰³

791. As part of a robust whistleblowing procedure, institutions must have effective systems in place to protect whistleblowers against detrimental treatment. **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.**

Record keeping

792. Existing guidance from the regulator encourages whistleblowers to raise their concerns internally in the first instance. We received evidence that many complaints that are framed as whistleblowing reports are in fact more appropriately categorised as individual grievances or disagreement with legitimate management decisions,¹³⁰⁴ and we recognise that this may sometimes be the case. **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.**

1302Ev 1631

1303Ev 1345

1304DQq 147, 363, 561

793. The Commission does, however, believe that it is important that a contemporaneous and independent record of every whistleblowing complaint exists, regardless of its eventual outcome. **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.**

The role of the regulator

Benefiting from whistleblowers

794. As explained above, one of the challenges facing regulators is that they are not as well placed as those within banks to spot problems. Whistleblowers therefore play an important role in bringing concerns to the attention of regulators. Banks must implement and administer appropriate and robust whistleblowing procedures. Nonetheless, there is also an important role for the regulator to play in overseeing the operation of banks’ internal whistleblowing procedures, in providing an alternative route for whistleblowing, and in providing support and encouragement to whistleblowers. The evidence that we received from whistleblowers demonstrated a lack of confidence in the regulator’s willingness and ability to support them and to act upon their concerns. Whistleblowers UK said that whistleblowers “have no confidence in the FSA”.¹³⁰⁵ Martin Woods, whose actions in disclosing wrongdoing at Wachovia were commended by the US Comptroller of the Currency, said that his experience with the FSA “should have been a better one”.¹³⁰⁶

795. Approved Persons are currently obliged to “deal with the FSA and with other regulators in an open and cooperative way and must disclose appropriately any information of which the FSA would reasonably expect notice.” (Principle 4 of the Statement of Principles for Approved Persons). Tracey McDermott described this Principle as providing an “obligation to whistleblow”,¹³⁰⁷ but acknowledged that it was questionable whether the FSA had been sufficiently assertive in enforcing it. She suggested that in many cases where wrongdoing was uncovered, the FSA had tended to focus on enforcement action for the wrongdoing itself rather than considering whether a breach of Principle 4 had also occurred.

796. 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.

1305Ev 1348

1306Ev 1632

1307 Q 3058

Encouraging whistleblowers

797. Regulators should be responsible for ensuring that firms have put in place an appropriate whistleblowing system. However, Martin Wheatley did not appear to believe that the FCA needed to do anything more to address the problems that whistleblowers may face:

The truth is, absent the question about incentives, that I am not sure that there is anything that we would need to add to the current structure. There is a high degree of protection for whistleblowers. They will sometimes need counselling if they are facing particular problems in a firm, and we would suggest areas that they can go to. We cannot provide that level of counselling. Our primary responsibility is to protect the identity of a whistleblower and to protect the source of information that comes to us.¹³⁰⁸

while protecting the anonymity of whistleblowers is important, this attitude gave support to Martin Woods's evidence of his experience:

At the end of the meeting the FSA gave me the telephone number of Public Concern at Work [...] and the FSA advised me to call them should I encounter any difficulties. This was the FSA's welfare programme for whistleblowers. The whole episode left me with a sense of emptiness and even further isolation.¹³⁰⁹

He told us that he later submitted a complaint to the FSA that he had been detrimentally treated by his employer for his whistleblowing, but did not receive any feedback from the FSA.¹³¹⁰

798. The FSA Handbook states that it “would regard as a serious matter any evidence that a firm had acted to the detriment of a worker because he had made a protected disclosure about matters which are relevant to the functions of the FSA. Such evidence could call into question the fitness and propriety of the firm or relevant members of its staff, and could therefore, if relevant, affect the firm's continuing satisfaction of threshold condition 5 (Suitability) or, for an Approved Person, his status as such.”¹³¹¹ The FSA told us that it

[...] would take seriously the suggestion that an FSA-regulated firm breached the requirements of the Public Interest Disclosure Act by penalising a member of staff who had made a protected disclosure. [...] There have been cases where whistleblowers have informed us that they believe their employer acted in a manner that led to the whistleblower suffering detriment as a consequence of making a protected disclosure. [...] To date, we have not undertaken detailed investigatory work or enforcement action against firms we regulate as a consequence of receiving accusations they mistreated a whistleblower.¹³¹²

1308Q 4472

1309Ev 1632

1310*ibid.*

1311FSA, *Senior Management Arrangements, Systems and Controls Sourcebook*, June 2013.p 18, www.fsahandbook.info

1312Ev 1059-1060

The FSA also said that actively monitoring employment tribunal cases brought by bank employees alleging detrimental treatment would not be cost-effective, large number of such cases brought each year.¹³¹³

799. 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.

800. The FSA told us that “if someone provides us with information which indicates that their fitness and propriety is in question then we have taken the view that we cannot, as the regulator, ignore that. So the consequences may be that an individual who comes forward is prohibited from working in the industry”.¹³¹⁴ The FSA acknowledged that this approach “acts as a further disincentive to report misbehaviour” and suggested that it could adopt a more lenient approach to whistleblowers who bring misconduct to its attention (with appropriate safeguards to ensure that other market users or customers were not put at risk). It said that it did operate leniency provisions in connection with insider dealing.¹³¹⁵ The PRA and the FCA have, however, now stated that a mitigating factor in deciding on any financial penalty can be the conduct of the individual in bringing the breach to the regulators’ attention.¹³¹⁶

801. One of the more controversial proposals to encourage whistleblowing is the use of financial incentives, as found in the United States. The most recent US scheme, introduced under the Dodd-Frank Act, provides for whistleblowers to be rewarded with a proportion of any fine levied on a company as a result of the information they have provided. Some of the evidence we received pressed strongly for the introduction of a similar scheme here. Erika Kelton, a US lawyer dealing with whistleblowing cases, described the impact of the US whistleblowing incentive schemes:

Tens of billions of dollars otherwise lost to illegal practices that cheat the public fisc have been recovered as a direct result of whistleblower information. But the impact and importance of whistleblower matters goes far beyond the large dollar amounts

1313Ev 1059

1314Ev 1058

1315*Ibid.*

1316Bank of England, Prudential Regulation Authority, *The PRA’s approach to enforcement: statutory statements of policy and procedure*, April 2013, Appendix 2, para 25, www.bankofengland.co.uk; PRA and FSA Handbook, DEPP 6.5B, www.fshandbook.info

recovered for US taxpayers. Whistleblowers have exposed grave wrongdoing, leading to changes that promote integrity and transparency in financial markets. Whistleblowers have helped stop massive mortgage frauds, gross mischarging practices, commodity price manipulation, and sophisticated money laundering schemes, among other misdeeds.¹³¹⁷

She argued that “meaningful, non-discretionary financial incentives are critical to establishing robust and successful whistleblower programs.”¹³¹⁸

802. The FSA had some serious reservations about the use of financial incentives, particularly in relation to the associated “moral hazards”. It argued that the prospect of already highly-paid individuals receiving a “reward” for doing what was arguably their duty could lead to public disquiet. Carol Sergeant, Chairman of the whistleblowing charity Public Concern at Work, also had reservations and suggested that financial incentives could encourage whistleblowers to delay reporting wrongdoing in order to maximise their reward.¹³¹⁹ Whistleblowers UK recognised the potential pitfalls of financial incentives, but argued that an incentive system based on a principle of compensation rather than reward would act as a recognition of the risks that a whistleblower undertook, while avoiding some of the associated moral hazard.¹³²⁰

803. 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.

804. 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.

805. 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.

1317Ev 1185

1318Ev 1186

1319EQ 113

1320Ev 1354

8 Remuneration

Introduction

806. In Chapter 3 we described how elements of remuneration in banking contributed to the problems of standards and culture in the sector. In particular, we noted:

- Remuneration is still higher than can be justified on the basis of performance;
- Incentives in investment banking and at the top of banks are linked to inappropriate measures that incentivise short-termism and a distorted approach to risk-taking; and
- Poorly constructed incentive schemes in retail banking have incentivised poor conduct.

807. In this chapter and Annex 6 we consider:

- i. the underlying causes of the flawed approach to remuneration in banking;
- ii. the current public policy framework, nationally and internationally, in relation to remuneration in the UK banking sector (see Annex 6);
- iii. the relationship between fixed and variable remuneration;
- iv. the various ways in which variable remuneration is set, the conditions on the release of variable remuneration and the forms which variable remuneration can and should take;
- v. the particular characteristics appropriate for remuneration for Board members;
- vi. the challenges of effecting change in this area given the international dimension; and
- vii. the implementation of proposed policy changes and the monitoring of underlying trends in remuneration in the sector.

Rewards out of kilter

Introduction

808. There are many causes of the flawed remuneration schemes that have contributed to problems of banking standards. In Chapter 3, we presented evidence that bankers have been paid in a fashion that incentivised undesirable conduct and risky behaviour. In turn, remuneration reinforced a culture whereby poor standards were considered normal. There are further underlying causes:

- i. senior bankers have enjoyed an imbalance between the potential personal upsides and downsides of their activity that has incentivised unduly risky decision-making;

- ii. distortions to the market, including the implicit guarantee and the related entrenched oligopolies that characterise parts of the industry, enable banks to extract value in excess of their economic contribution, much of which is distributed to staff; and
- iii. structural imperfections in bank corporate governance that tend to contribute to the escalation of remuneration.

These further underlying causes are considered in further detail below.

The one-way bet

809. At the heart of the problem with much of bankers' remuneration is a misalignment of risk and reward. The potential rewards for bankers if things go well are huge, but if things go badly, there is less downside. Remuneration practices have brought about what Virgin Money termed a "heads we win, tails you lose" culture.¹³²¹ This problem is not new, as Box 14 demonstrates.

Box 14: The One Way Bet

The 1929 crash was investigated by US Senate Committee on Banking and Currency in the "Pecora Inquiry". The Committee took evidence from Albert H Wiggin, Chairman of Chase National Bank on his high pay and bonuses. For example, in 1928, Mr Wiggin was paid a salary of \$175,000 and a bonus of \$100,000, equivalent to approximately \$2.4 million and \$1.4 million in today's prices.¹³²² The Pecora Report noted "additional compensations were paid in profitable times, without any charge-off in the periods when losses were sustained by the bank":

Senator Adams: Upon what theory were those bonuses paid?

Mr Wiggin: Additional compensation in profitable times, on the theory that the salaries of the officers, which were distributed all through the entire staff, you know----

Senator Adams: They credited you with being responsible for some of their added profits in the good years

Mr Wiggin: I think so, sir.

Senator Adams: In the bad years did they charge you in any way with responsibility for losses?

Mr Wiggin: No, sir.

Senator Adams: It has only worked one way?

Mr Wiggin: Only one way.¹³²³

¹³²¹Ev 1423

¹³²²US Bureau of Labor Statistics, *CPI inflation calculator*, www.bls.gov

¹³²³US Senate Committee on Banking and Currency, *The Pecora Investigation: Stock Exchange Practices and the Causes of the 1929 Wall Street Crash* (Cosimo, 2010, originally published 1934), p 208

810. Historically, British merchant banks and their US counterparts, investment banks, were private partnerships. The ABI told us that partners were rewarded for risking their wealth:

They paid substantial bonuses for value created during good times, but real downside risks were run and partners' capital was on the line.¹³²⁴

Andy Haldane told us that in a partnership model, bankers “have skin in the game right up until the death”.¹³²⁵ Sir Mervyn King argued that investment banking “is an activity whose natural form of activity is a partnership, rather than a limited liability company”.¹³²⁶

811. In 1999, Goldman Sachs, under the co-Executive Chairmanship of Jon Corzine and Hank Paulson, became the last major investment bank to float.¹³²⁷ All the major international banks that operate in London are now public companies. Michael Cohrs noted that financial services firms with partnership models, such as many hedge funds, tended to perform better in the aftermath of the financial crisis.¹³²⁸ Referring to Goldman Sachs’ strong risk management record, Sir Mervyn King said that “for over a century they were a partnership and learned how to manage risk, and they say they have not forgotten it”.¹³²⁹ However, Michael Cohrs cautioned that it was “hard to imagine” a return to a partnership structure given the size of modern banks.¹³³⁰

812. Employees of listed banks face much more limited personal losses or exposures in the event of assets defaulting or the company failing, than do partners. Dr Alexander Pepper of the Department of Management at the London School of Economics and Political Science said that:

I have no problem with people being highly regarded if they take high risks. Successful entrepreneurs earn huge sums of money, but they take huge risks. The problem in people’s minds with banking and executive pay is that they believe the relationship between risk and reward has broken down and I would agree with that.¹³³¹

As a result, as the ABI told us, “bonuses have become a free option on the upside for banks” employees, with no corresponding share in the downside”.¹³³² This creates incentives for bankers to make risky bets with shareholders’ capital. We noted in Chapter 3 that remuneration systems based on short-term financial measures have similar effects.

1324Ev 745

1325Q 622

1326Q 4561

1327 “The Company File: Goldman Sachs will float”, *BBC News*, 8 March 1999, www.bbc.co.uk/news

1328EQ 31

1329Q 4563

1330EQ 31

1331Q 3232

1332Ev 745

813. Due to the long term nature of the assets and the liabilities in banking, risks often do not materialise until some years after the event from which they arise. So-called “Long Term Incentive Plans” (LTIPS) typically defer pay for three to five years.¹³³³ This does not reflect the length of time over which risks in banking can materialise. For example, a business cycle lasts around seven years,¹³³⁴ while, in the case of mis-selling, “the poor quality and suitability of the product often does not become apparent until many years after it is sold”.¹³³⁵

814. In addition, the proportion of remuneration that is currently deferred is low. The following table sets out the outstanding aggregate sums of deferred remuneration at the five quoted UK banks, for the years this information was disclosed:

Deferred compensation outstanding and as a proportion of total compensation										
	Barclays		HSBC Group		LBG		RBS		Standard Chartered	
	(£m)	(%)	(\$m)	(%)	(£m)	(%)	(£m)	(%)	(\$m)	(%)
2009					71	1.1				
2010	1,749	16.0	1,580	8.0	78	1.2	750	8.4		
2011	2,006	19.3	1,100	5.2	72	1.2	550	6.7	492	7.4
2012	1,698	17.4	731	3.6	52	0.9	401	5.2	470	7.1

Source: Company Annual Reports

At Barclays, which has the largest investment banking business of the five banks, deferred compensation outstanding was equivalent to one-sixth of total compensation in 2012. In the other banks, it was lower still: the total outstanding sum of deferred compensation at LBG was just £52m at the end of 2012. This represented less than one per cent of 2012 staff costs and compared with a total aggregate of £6.8bn provided against PPI related costs.¹³³⁶ Deferred remuneration has also generally been on a downward trend, as variable compensation has fallen and the proportion that is fixed has risen.

815. A further characteristic of deferral as it has operated in recent years is that it is common for employees to lose their entitlement to deferred payments when they leave a firm. A new firm will often therefore offer to “buy out” the deferred payments to compensate the employee for these lost payments and incentivise them to change allegiance. Andrew Williams, UBS Head of Global Compliance, explained how this affected the ability to claw back sums from a former employee of that bank implicated in LIBOR misconduct:

When Mr Hayes left us to join Citi, under the terms of our compensation schemes, all his deferred compensation was forfeited. So he wouldn't have had anything to claw back. It is usual within the industry that where one joins a competitor organisation, the deferred compensation is forfeited. Sometimes it is replaced, a bit

1333EQ 164

1334EQ 5

1335Ev 1460

1336Lloyds Banking Group, *Annual Report & Accounts 2012*, p 240, www.lloydsbankinggroup.com

like a transfer fee to use a football analogy. So it is replaced by the new organisation. But Mr Hayes has no compensation from us to claw back.¹³³⁷

816. Pension entitlements also act to reinforce the one way bet, enabling individuals to accumulate substantial pots of wealth insulated from the effects of failure. James Crosby retired from HBOS in 2006, two years before that bank's collapse, with a pension transfer value of £10.4m.¹³³⁸ Because Fred Goodwin was asked to retire early, the value of his pension increased by £8.3 million in 2008, reflecting the full pension rights he would have accrued had he worked until aged 60, assuming, of course, that RBS still existed. The following table sets out the transfer values of the accrued pension rights,¹³³⁹ of the executive directors of UK banks that received equity support from the taxpayer during the crisis:

Transfer value of pension rights accrued by executive directors of banks receiving state equity support (£000s)								
	HBOS		RBS		B&B		Northern Rock	
Cummings	7,090	Pell	9,831	Crawshaw	3,589	Applegarth	2,618	
Dawson	1,394	Goodwin	16,630	Dickie	488	Baker	4,307	
Hornby	2,813	Cameron	1,363	Hattam	393	Bennett	6,684	
Matthew	9,089	Fish	\$27,004	Stevens	85	Currie	2,520	
Watkins	2,845	Fisher	4,810			Jones	1,124	
						Kuipers	1,562	

Source: company Annual Report & Accounts

After significant public pressure, Fred Goodwin agreed to reduce the value of his pension rights by one-third to £12.2m, comprising a lump sum of £2.7m and an annual pension of £342,500.¹³⁴⁰ Following our Report into the failure of HBOS, James Crosby announced that he would voluntarily forgo one-third of his pension entitlements, leading to reduction in his annual income from that source from about £580,000 to around £400,000.¹³⁴¹

Harvesting the fruits of market distortion

817. In Chapter 3, we described the implicit taxpayer guarantee, made explicit in the aftermath of the financial crisis, which continues to be enjoyed by banks. Douglas Flint, Group Chairman of HSBC Holdings, argued that “the implicit subsidy that the Government gave was passed on to customers”.¹³⁴² Other witnesses disagreed. Andrew Bailey directly linked high pay to the implicit subsidy:

1337Q1935

1338 “HBOS accused of misleading investors over Sir James Crosby’s £2m pension top up”, *The Telegraph*, 10 April 2013, www.telegraph.co.uk The transfer value represents the capital sum which pension providers would pay or receive on the transfer of an individual member’s pension rights. It therefore represents a measure of the total capital sum represented by the member’s pension rights.

1339 HBOS, *Annual Report and Accounts 2008*, p 66, www.lloydsbankinggroup.com; RBS, *Annual Report and Accounts 2008*, p 168, www.investors.rbs.com; Bradford and Bingley, *Annual Report and Accounts 2008*, p 28, www.bbg.co.uk; Northern Rock, *Business Plan and Annual Accounts 2008*, pp 12-13

1340 “Goodwin hands back part of pension”, *The Financial Times*, 18 June 2009, www.ft.com

1341 “Sir James Crosby statement: in full”, *The Telegraph*, 9 April 2013, www.telegraph.co.uk

1342Q 545

why is remuneration so high, as a level, in this industry. To address that, you have got to get to the question of “too big to fail”, and the question of the implicit subsidy.¹³⁴³

Sir Mervyn King concurred:

If we could manage to resolve the “too big to fail” problem, I don’t believe you would find the scale and form of remuneration of the type that it is. It is very much an example of what economists call rent-seeking behaviour.¹³⁴⁴

The concept of rent-seeking is considered in Box 15.

Box 15: Economic rent

Economic rent is income in excess of the minimum needed to attract an individual or firm to conduct a task. If a model would not get out of bed for less than \$10,000, but is paid \$15,000 for doing so, she is extracting economic rent of \$5,000.

Economic rent derives from imperfections in the market. In a perfectly competitive market, economic rent is entirely driven out: the model is undercut by other models until she is only paid \$10,000, just enough to do the work. This equivalent to her opportunity cost: the value to her of staying in bed instead.

Payments in excess of opportunity cost can serve an economic purpose. Joseph Schumpeter wrote of entrepreneurial rent, the extra profits enjoyed by an innovator between an idea’s adoption and its imitation.¹³⁴⁵ However, rent-seeking, the process of striving to extract economic rent or creating barriers to prevent rents being competed away, can be value-destroying. John Kay wrote that “whenever the balance shifts too far in favour of appropriation over creation, we see entrepreneurial talent diverted to unproductive activity, an accelerating cycle in which political power and economic power reinforce each other”.¹³⁴⁶

In *The Trouble with Markets, Saving Capitalism from Itself*, Roger Bootle argued that finance offers unique opportunities for rent-seeking.¹³⁴⁷ Asymmetries of information, whereby the bank understood more about the merits of its products than the purchaser, were arguably behind both the sale of both securitised subprime loans and PPI. Similarly, the implicit guarantee was exploited for unearned profit: what Paul Sharma described as “the farming of [...] the too big to fail”.¹³⁴⁸

818. Bill Winters told us that investment banker remuneration in universal banks was inflated by the guarantee. The subsidy allowed “banks to operate with tremendous advantages relative to any others participating in capital markets”. The consequence was a

1343Q 4509

1344Q 4529

1345 Joseph Schumpeter, *Capitalism, Socialism and Democracy*, (Routledge, 1994, first published 1942)

1346 “The monumental folly of rent-seeking”, *The Financial Times*, 20 November 2012, www.ft.com

1347 Roger Bootle, *The Trouble with Markets, Saving Capitalism from Itself*, (Nicholas Brealey, 2009)

1348Q 3369

“transfer of value from taxpayers to banks and from banks to bankers”.¹³⁴⁹ The taxpayer guarantee has a mutually-reinforcing relationship with oligopoly. Andy Haldane has dubbed this a “self-perpetuating doom loop”:

[A] rise in banking scale and concentration has [escalated] expectations of state support for the banking system. These expectations generate lower funding costs, in particular for the largest banks, which in turn encourages further expansion and concentration, worsening the too-big-to-fail dilemma.¹³⁵⁰

819. Roger Bootle has suggested that investment banking itself operates as an oligopoly, noting that market concentration has increased since the 2007-08 financial crisis, an issue discussed. He has linked this lack of competition to high levels of remuneration:

Insiders are virtually never challenged by outsiders. Because reputation is so important, it is very difficult for a new financial firm to get going without having seasoned professionals – and to employ them it will have to pay at least the established market rate, if not more. [...] Ironically, the very tendency for pay in financial services to settle well above the “competitive” level, and for employees to take a large proportion of the profits when things go well, acts as a barrier to entry for new firms and hence an explanation as to why high profitability can persist.¹³⁵¹

Paul Volcker said that the spread of the compensation culture of investment banking was behind some of the worst excesses seen in retail banks:

It went wild. Why did that go wild? I would argue that the compensation practices that crept in, and the very large compensation in the trading parts of banks, infected the culture of the institutions generally, so the lending offices dreamt things up—how to make a lot of money in the short run and get a big bonus.¹³⁵²

Referring to his experience of the merger between J.P. Morgan & Co, an investment bank, and Chase Manhattan, primarily a retail bank, in 2000, Bill Winters noted that “there were people running mid-sized businesses in credit cards, mortgages, consumer loans or small business lending who were paid well above their counterparts at pure retail banks, because they were being measured against investment banking-type metrics”.¹³⁵³

820. Many bank staff are not highly paid. Antony Jenkins told us that Barclays “employ people who make £12,000 per year and [...] people who make many, many multiples of that”.¹³⁵⁴ The latest Barclays Annual Report showed that, while it hands out very large rewards to hundreds of staff, more than half of its 140,000 employees, concentrated in its retail division, earn less than £25,000 per year.¹³⁵⁵ Ged Nichols and Helen Weir both told us

1349Q 3681

1350Bank of England, *On being the right size speech*, Andy Haldane, 25 October 2012, www.bankofengland.co.uk

1351Roger Bootle, *The Trouble with Markets, Saving Capitalism from Itself*, (Nicholas Brealey,2009)

1352Q 61

1353Q 3682

1354Q 3546

1355Barclays, *Annual Report and Accounts 2012*, www.barclays.com

that staff selling PPI in branches would have been paid around £20,000 per year.¹³⁵⁶ However, high remuneration is not restricted to investment banking. Lloyds Banking Group is predominantly a traditional banking institution, with 90 per cent of its assets already inside the anticipated ring-fence.¹³⁵⁷ In 2012 it paid 25 staff over £1 million, including five between £2 million and £3 million.¹³⁵⁸ The most highly paid executive, Chief Executive Antonio Horta-Osório, received total emoluments of £3.4 million.¹³⁵⁹ Santander UK, a retail bank, awarded its Chief Executive, Ana Botín, £4 million in 2012, including a salary of £2 million. It paid a further 18 staff over £1 million.¹³⁶⁰

Banks will not solve this themselves

Introduction

821. It is not in the interests of companies or their owners systematically to pay staff more than they are worth for a sustained period. Likewise, it is not in their interests to encourage staff to take unsustainable or reckless risks with the firm's money or reputation. However, banks and their shareholders have sanctioned and, in many cases encouraged, such practices. In this section we consider why banks consistently pay bankers too much to do the wrong things.

Shareholders

822. We noted in Chapter 3 that shareholders are not adequately incentivised or equipped at present to discipline or constrain banks' behaviour.¹³⁶¹ On the contrary, shareholders have, on occasions, increased pressure upon bank management to adopt high-risk, short-term strategies.

823. Profits in a public company are split three ways. Shareholder returns, in the form of dividends, compete with employee remuneration and retained profits held as capital. The ABI told us that with respect to banks, "in recent years this balance has been inequitable, with too much value being delivered to employees in contrast to the dividends paid to shareholders".¹³⁶² Sir Mervyn King concurred:

it is striking that, looking back at the returns that investment banking has generated, almost all of them have gone to the employees in the industry and not to the shareholders.¹³⁶³

1356JQ 300, JQ 633

1357Lloyds Banking group, *2012 Half-Year Results presentation*, Antonio Horta-Osório, 26 July 2012, p 20, www.lloydsbankinggroup.com

1358"Notification of transactions by PDMRs and other remuneration disclosures", Lloyds Banking Group press release, 25 March 2013, www.lloydsbankinggroup.com

1359Lloyds Banking Group, *Annual Report & Accounts 2012* p107, www.lloydsbankinggroup.co.uk

1360Santander UK, *Annual Report & Account 2012*, p 179, www.santander.co.uk

1361See paras 173-176.

1362Ev 748

1363Q 4561

The NAPF said that there was “there is a need for a fundamental rethink of executive pay structures to ensure better alignment between rewards to management and the interests of long-term investors”.¹³⁶⁴ PwC set out evidence that this distribution is currently further out-of-kilter than it was pre-crisis:

In order to deliver double digit [RoE] returns post crisis, the industry would have needed to deliver a compensation to profit ratio below 50 per cent, given the increase in capital and reduction in profits [...]. Instead the ratio increased to over 70 per cent by 2011. This was because falls in profit and increases in equity more than offset the reductions in pay and resulted in both higher capital intensity and a higher proportion of profits paid to employees.¹³⁶⁵

824. Virgin Money told us “excessive remuneration reflects weak market discipline by shareholders”.¹³⁶⁶ Sir David Walker said that deleveraging required to meet more stringent post-crisis capital requirements should result in shareholders being “much more attentive” to the “carve out” of returns between them and employees.¹³⁶⁷ However, there has been little evidence of meaningful shareholder action. Even during the 2012 AGM season, which was dubbed the ‘shareholder spring’, only two FTSE 100 companies, neither of them banks, had their remuneration reports defeated. Barclays, which had the largest dissenting vote among banks, had its Remuneration Report accepted by 73 per cent of votes cast in 2012. This rose to 95 per cent in 2013.¹³⁶⁸ Dr Tracy Long, founder of Boardroom Review, told us that the lack of shareholder engagement was:

not for lack of trying. Most chairmen, most senior independent directors and most remuneration committee chairmen have tried and tried and tried to see their shareholders. Very often their shareholders show no interest whatsoever in seeing them [...].¹³⁶⁹

The talented Mr Ricci

825. Rich Ricci left his position as head of investment banking at Barclays in April 2013, a few weeks after receiving £18 million in deferred remuneration. *The Financial Times* reported that Mr Ricci “enjoyed £67.4 million of deferred share awards” during four years he served on the Barclays Group Executive Committee.¹³⁷⁰ He had joined that Committee in 2009, on the same day as Jerry del Missier, Tom Kalaris and Antony Jenkins. The accompanying press release described the appointments as “promoting new talent to the most senior executive level”.¹³⁷¹ Talent at Barclays did not come cheap.

1364Ev 1262

1365C Ev 152

1366Ev 1423

1367Q 41

1368“Barclays Shareholders Approve Remuneration Report”, *Wall Street Journal*, 25 April 2013, www.wsj.com

1369CQ 14

1370“Barclays retires last two from old regime”, *The Financial Times*, 18 April 2013, www.ft.com

1371“Barclays Broadens Executive Committee”, Barclays press release, 3 November 2009, www.barclays.com

826. Antony Jenkins told the Commission that “levels of pay are important because you have to be competitive to attract the best talent”.¹³⁷² Banks, including Barclays, UBS and RBS in investment banking, convinced themselves during the pre-crisis boom that to grow quickly, they should pay over the odds for talented individuals. Andrea Orcel, Chief Executive Officer of the UBS investment bank, explained:

I think this is an industry where either via balance sheet or via inflation of salaries you can increase your market share—not your profits—relatively easily, at least for a period of time.¹³⁷³

As well as driving the expensive recruitment of staff, the retention of talent also inflated the salaries of incumbent staff, as David Bolchover, a management writer, explained:

The trader who wants $x + y$ has a boss who wants $2x + 2y$. He says, “This guy who works below me is so talented. Please’ – to the guy above him who earns $3x + 3y$ – ‘we can’t lose this guy. He can’t go to a competitor. And guess what? I am his boss, so, by inference, I must be even more capable and talented than him. So don’t lose me either.’¹³⁷⁴

827. David Bolchover argued that high remuneration in banking had been justified by the flawed argument that “only an extremely limited amount of people can do these jobs and therefore, by the laws of supply and demand, their pay should be extremely high”. He suggested that this claim was not backed up by “proper evidence”,¹³⁷⁵ and that it benefited people with “no particularly rare talent, who have not taken a risk and whose impact is questionable, capitalising on the fact that they are meeting very little resistance to their arguments”.¹³⁷⁶ Justifying his own \$1.5 emoluments for two days per week of work for the Board of a non-UK subsidiary of HSBC, John Thornton argued that “It is not full-time, but it is very involved.”¹³⁷⁷ Adam Posen dismissed “the idea of the magical CEO or CFO, or future CEO [...] someone of great perspicacity and leadership”, arguing that “very few people are irreplaceable [and] can substitute for one another”.¹³⁷⁸ The Salz Review of Barclays cited an interviewee who claimed that the system rewarded mediocrity:

the scandal of banker pay was less that of the star performer, but of the mediocre banker who, under the umbrella of a star and benefiting from the franchise of a top investment bank, received disproportionate reward simply for being there.¹³⁷⁹

828. Alison Carnwath, the former Chairman of the Barclays Remuneration Committee (RemCo), argued that Bob Diamond used high remuneration as a management tool:

1372Q 3545

1373Q 1996

1374Q 3225

1375Q 3194

1376Q 3210

1377Q 3285

1378Q 2699

1379Salz review: *An independent Review of Barclays’ Business Practices*, April 2013, para 11.17

I really believe that he thought he found loyalty in people around him by paying them very well—in my view, more than he needed to.¹³⁸⁰

Ms Carnwath suggested that Mr Diamond, “notwithstanding Barclays overall results[,] felt it necessary to retain bankers in anticipation of an upswing in business activities and to retain their loyalty”.¹³⁸¹

Boards, benchmarking and the ratchet effect

829. PwC suggested that the “role of benchmarking and competitiveness considerations” in investment banking remuneration has increased in recent years. This was, they contended, partly due to banks competing to “build investment banking capability”.¹³⁸² Lloyds Banking Group referred to the creation, by fears of losing staff, of a “ratchet effect on pay and bonus levels as companies sought to protect their franchise”.¹³⁸³ The TUC explained this effect in more detail:

To determine executive pay, remuneration committees design a comparator group, normally based on the advice of remuneration consultants. These comparator groups are normally based on a mix of market capitalisation and industry type. Once designed, the comparator group is used as a benchmark against which to measure reward and performance. The use of these comparator groups has been extensively criticised as a cause for ratcheting up pay as a result of both poorly designed groups and the prevalent practice of seeking to pay above median or upper quartile rates.¹³⁸⁴

830. Fidelity Worldwide Investment said that the “inflationary dynamic fuelled by a desire to achieve a second quartile reward profile” was fuelled by “progressively more complex remuneration arrangements encouraged by a new profession of remuneration consultants”.¹³⁸⁵ David Bolchover argued that there was “an extremely powerful nexus” comprising “headhunters, remuneration consultants and remuneration committees [with] a vested interest in high pay”.¹³⁸⁶ Mr Bolchover argued that “a clear conflict of interest” led to remuneration consultants acting to inflate pay in banking, because they were “hired by the executives, whom they then recommend to be paid very well”.¹³⁸⁷ Carol Arrowsmith, a remuneration consultant, denied this, stating that they are generally appointed by non-executives and, most typically, the Chairman of the Remuneration Committee.¹³⁸⁸

831. The FSA summarised the role of RemCos as “to exercise competent and independent judgement on the bank’s remuneration policies and practices”.¹³⁸⁹ However, several

1380Q 3266

1381C Ev 149

1382C Ev 157

1383Ev 1220

1384Written evidence from the High Pay Centre to the Treasury Committee (CGR 02), May 2012 [not printed], www.parliament.uk/treascom

1385Ev 1016

1386Q 3194

1387Q 3196

1388Q 3203

1389C Ev 166

witnesses told us that a shared outlook with the Chief Executive and Chairman, rather than independence, was vital to the success of a Remco. Alison Carnwath said that it was important that they were “on the same wavelength”.¹³⁹⁰ Paul Sharma stated that “the RemCo works very well when it is aligned with the Chairman and the Chief Executive. Really it gets quite difficult when it is not”.¹³⁹¹

832. Mr Sharma told us that reforming RemCos “can only take you so far” in improving standards. This, he said, was because “the basic culture issue is not addressed. The RemCo in and of itself can’t solve the problem”.¹³⁹² The evidence we took from one RemCo Chairman, Sir John Sunderland, Chairman of the Barclays RemCo, in particular drew into question the ability of his Committee to effect cultural change through remuneration reform. Sir John stood by his support, as a then member of the RemCo, for the board’s decision, against the advice of Alison Carnwath, the then RemCo Chairman, to award the then Chief Executive, Bob Diamond, a bonus for 2011. Sir John explained why he felt the bonus, of over £1.7 million¹³⁹³ in addition to a salary of £1.35 million,¹³⁹⁴ was deserved despite the poor financial performance of Barclays and emerging evidence of conduct failures:

the bank was not returning a positive return equity versus its cost [but] the board took the view that Mr Diamond’s performance overall, the enthusiasm, skills and ability that he brought to bear, deserved some recognition.¹³⁹⁵

Sir John Sunderland later stated that a reduction in an individual’s salary from one year to the next would be a “dramatic shift, and a very new concept”¹³⁹⁶ and an “interesting concept”.¹³⁹⁷

833. The current Chairman of Barclays, Sir David Walker, declined to criticise his RemCo Chairman on either count,¹³⁹⁸ because Sir David was “not interested in disinterring what might have happened in the past”.¹³⁹⁹ He said that base salaries at Barclays were not considered an incentive, but were “set by reference to standards internationally”.¹⁴⁰⁰ Responding to criticism of Barclays’ decision to pay 428 employees more than £1 million in 2012,¹⁴⁰¹ Sir David said that remuneration levels were “about right now” at his bank.¹⁴⁰²

1390Qq 3276-7

1391Q 3380

1392*Ibid.*

1393Q 3268

1394Q 3326

1395Q 3322

1396Q 3364

1397Q 3366

1398Qq 3528, 3534

1399Q 3528

1400Q 3537

1401Barclays, *Annual Report and Accounts 2012*, www.barclays.com

1402“Barclays shareholders criticise pay levels”, *The Financial Times*, 25 April 2013, www.ft.com

834. Antony Jenkins told us that Barclays have now adopted the policy of not “paying in the top quartile in aggregate as an organisation”, although they would do so for “certain roles”.¹⁴⁰³ PwC expressed “surprise that investment bank pay has not fallen faster given the high starting point” and the wider environment in which the industry operated. They partly attributed this stickiness in remuneration to a “survivor strategy” aimed at “retaining key talent” to take advantage of a subsequent economic upswing with fewer competitors.¹⁴⁰⁴ Carol Arrowsmith acknowledged that it could be difficult for remuneration committees to recommend bottom-quartile pay, because “it is always nice—it is a bit like everything in life—to hand out prizes”.¹⁴⁰⁵

835. Alison Carnwath told us that investment banking has been characterised by what she described as a “sense of entitlement [resulting in] obscene levels of award in a minority of cases and excessive reward in many cases”.¹⁴⁰⁶ The Salz Review of Barclays explored this concept:

When revenue leads directly to pay, with insufficient consideration of other measures of success such as safeguarding reputation or respect for others, it is an enormous challenge to prevent a cultural drift toward a sense of entitlement. It is difficult for employees to give up that which they have been led to expect.¹⁴⁰⁷

In their written evidence, PwC suggested that the “psychological difficulty of cutting pay” was an important factor in the failure of rewards in investment banking to fall to levels commensurate with profitability.¹⁴⁰⁸

Conclusions

836. 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.

837. Aggregate remuneration continues to consume a high share of returns relative to shareholder dividends and capital. From this share, a relatively small proportion of

1403Q 3545

1404C Ev 155

1405Q 3201

1406Q 3258

1407Salz review: *An independent Review of Barclays’ Business Practices*, April 2013, para 8.41

1408C Ev 155

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.

838. 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.

839. 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.

The current policy framework

840. The remuneration of bankers, and director and executive pay in general, has been subject to substantial public policy change in recent years, much of which continues. The developments include:

- the international Financial Stability Board Principles for Sound Compensation Practices and their Implementation Standards, introduced in 2009;
- the FSA Remuneration Code, which intends to align bank remuneration with risk, introduced in August 2009 and updated in January 2011 to implement the provisions of the Third Capital Requirements Directive (CRD III);
- the Fourth Capital Requirements Directive (CRD IV), likely to be implemented in 2014, which includes provisions for a cap on bonuses paid to certain bankers as a multiple of fixed remuneration and increased pay transparency requirements; and
- amendments to the Companies Act 2006 requirements of quoted companies, made in the Enterprise and Regulatory Reform Act 2013, including a binding shareholder vote on the remuneration of directors.

The current public policy framework is set out in more detail in Annex 6.

Fixed and variable remuneration

Introduction

841. For much of the public, the excesses of banking in recent years are epitomised by enormous bonuses. Chapter 3 described how, though the level of cash bonuses has fallen in recent years, overall remuneration in major banks has largely been sustained through a shift towards more fixed remuneration. This section examines the relationship between fixed and variable remuneration and its policy implications.

Why banks pay bonuses

842. PwC set out three major benefits to banks of paying a high proportion of remuneration in variable form:

- it enables cost flexibility in face of variations in firm performance;
- it enables strong differentiation in pay between low and high performing areas; and
- it enables rapid cost reductions for business areas or individual employees being exited by the firm.¹⁴⁰⁹

Nomura told the Treasury Committee that “the cyclical nature of investment banking revenues required firms to manage their staff costs carefully through economic cycles” and that paying variable bonuses meant that investment banks could “keep down their variable costs in lean times, while continuing to pay for performance”.¹⁴¹⁰

843. PwC emphasised that investment bank bonuses were considered, by both banks and their employees, a normal part of compensation for satisfactory performance:

the construct of an investment bank pool means that a ‘bonus’ is not an added extra for outperformance. It is part of an employee’s expected total pay if they and their business area perform adequately. This disconnect between common understanding of the word ‘bonus’ and its manifestation in an investment bank creates the potential for misguided regulation, based on an erroneous presumption that base salary is the ‘rate for the job’ with bonuses only paid for exceptional performance.¹⁴¹¹

844. Andrew Bailey warned that fixed remuneration is “essentially cash out of the door” and that it was much harder to recoup pay “once it has been paid [...] rather than when it is deferred and unvested”.¹⁴¹² Douglas Flint identified the “paradox [that] there is quite a lot of public support for clawback, which can only happen with deferral and deferral can only happen with bonus. You cannot defer someone’s salary”.¹⁴¹³ Erkki Liikanen concurred that

1409C Ev 57

1410Treasury Committee, Ninth Report of 2008-09, *Banking Crisis: reforming corporate governance and pay in the City*, HC 997, para 16

1411C Ev 157

1412Q 4509

1413Q 3828

“if you limit [variability] it takes away the flexibility [...] so that if the minimum salary is low there can be a high variable, then if the bank goes badly they just go down”. However, Mr Liikanen went on to say that the ratio of variable to fixed remuneration had “grown too wide and has a negative impact on the long-term commitments”:

this basic principle holds that the variable part should not be too high compared to the permanent one. It has impact on [...] behaviour which is not positive in the long term.¹⁴¹⁴

The EU bonus cap

845. In May 2013, the European Union agreed to cap the variable pay of particular bank staff at a maximum of 100 per cent of fixed pay, increasing to 200 per cent of fixed pay with the explicit agreement of shareholders. Bonus payments could account for, at the very most, two thirds of a European banker’s annual remuneration. These provisions are enshrined in CRD IV and must be implemented by Member States by 1 January 2014. Previously, it had been thought that the bonus cap would only apply to employees classed as “material risk-takers”. However, Europe’s banking regulator, the European Banking Authority, has now broadened its definition to cover more financial services staff with the criteria widened to include staff earning more than €500,000 (currently approximately £420,000) per annum.¹⁴¹⁵

846. The economic case for a bonus cap was well put by *The Financial Times*:

Incentives work. People respond to them. Remuneration skewed towards short-term performance encourages risk-seeking behaviour in the short term. This is close to a verity; in the short term, all you need to do to make more money for a bank is take more risk.

Bonuses are asymmetric; they are not so variable that traders can be required to hand money back to shareholders in years when their trades come unstuck. This asymmetry will continue under the proposal, but at least it will be limited.

Reducing the variability of bonuses at a stroke reduces the incentives to take extra risks, while leaving ample room to compensate good performance. For anyone other than a trader, used to “eating what they kill”, a 200 per cent bonus is ample.¹⁴¹⁶

847. Andrew Bailey warned that the bonus cap would “push up fixed remuneration” rather than act to reduce overall pay.¹⁴¹⁷ Sir David Walker told us that the cap had already had this effect in some institutions.¹⁴¹⁸ PwC cautioned that a reduction of flexibility in remuneration could result in volatility:

1414Q 144

1415European Banking Authority, *Draft regulatory technical standards*, 21 May 2013, p 14, www.eba.europa.eu

1416“Bonuses are a symptom of banks’ problems”, *The Financial Times*, 3 March 2013, www.ft.com

1417Q 4509

1418Q 3533

the revenue threshold at which individual business lines would be viable would be raised leading to the requirement to exit underperforming businesses more quickly, thereby increasing volatility in business performance and employment.¹⁴¹⁹

Several witnesses argued that increases in fixed pay to compensate for reductions in variable remuneration could have undesirable behavioural effects. Sir Mervyn King argued that “to give banks an incentive to raise the fixed remuneration at present, which is what the proposed rules would do, is to go in the wrong direction”.¹⁴²⁰ Jon Terry, remuneration partner at PricewaterhouseCoopers, argued that “introducing bonus caps runs the material risk of increasing risk, rather than reducing it”.¹⁴²¹

848. Lord Turner noted that the cap could reduce the potential for recouping deferred awards:

The danger of the cap on bonuses [...] is that if salaries simply increase as a result, we will have less that we can force to be deferred and therefore force to be clawed back. It is quite right that we have made bonuses deferred, paid in either equity or bail-inable debt, and subject to clawback. If you go too far in the direction of saying that there should not be bonuses at all, we lose an element of flexibility.¹⁴²²

Lord Turner concluded that, while he was “sympathetic to the objectives of many people who are in favour” of the cap, further reform to the structure of variable remuneration would be more effective than limits on levels:

if we were to make the existing codes stronger, we would do better to lengthen deferral periods and demand that more of the bonus be paid in bail-inable debt or other instruments that disappear in failure, rather than insisting on a cap on bonus. I think those would be more intelligent strengthenings of the current regime.¹⁴²³

849. Jon Terry, a partner in the reward and compensation practice at PwC, argued that the bonus cap “could seriously undermine the competitiveness of EU banks outside the EU” and would encourage banks “to build new capabilities in New York, Hong Kong or Singapore instead of Europe”. This, he said, would “harm employment, not just of bankers but in the wider economy”.¹⁴²⁴ Sir Mervyn King cautioned that banks would find a way around the cap:

given the imagination that will inevitably be directed to finding ways around this and the various details associated with it, it will be anywhere near as effective as its proponents believe it will be. Neither, for that reason, is it likely to be as damaging.¹⁴²⁵

1419C Ev 158

1420Q 4565

1421 “*Bankers' bonus caps—PwC comments*”, PwC press release on 28 February 2013

1422Q 4483

1423*Ibid.*

1424 “*Bankers' bonus caps—PwC comments*”, PwC press release on 28 February 2013

1425Q 4529

Sir Mervyn told us that the debate on the bonus cap was actually a “bit of a distraction” characterised by “a great deal of sound and fury about the proposals”.¹⁴²⁶ He argued that it was:

one of those measures that will have neither the intended effects that its proponents believe nor be as damaging as its detractors fear. The risk is that it will simply deflect attention away from the real issues.¹⁴²⁷

The Commission’s proposals for reform to variable remuneration are set out in subsequent sections of this chapter.

Conclusions

850. **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.**

851. **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

Company financial performance

852. In Chapter 3, we noted that the use of return on equity (RoE) in calculating variable remuneration has incentivised short-termism, risk-taking and high leverage. The November 2012 Financial Stability Report noted that, while “there is evidence to suggest that a number of banks have reduced somewhat their reliance” on measures such as RoE, “there is further to go and there is a risk that this progress could be easily reversed in future, particularly when external conditions improve”.¹⁴²⁸

853. Tim Bush, Head of Financial Analysis at PIRC, but writing to the Commission in a personal capacity, was in favour of use of return on assets (RoA) as an alternative to RoE, arguing that it “not only avoids the moral hazard that return on equity gives, it may also

¹⁴²⁶*Ibid.*

¹⁴²⁷*Ibid.*

¹⁴²⁸Bank of England, *Financial Stability Report*, Issue Number 32, November 2012, p 56, www.bankofengland.co.uk

serve to incentivise bringing more assets back on balance sheet”.¹⁴²⁹ Andy Haldane, who was also in favour of greater use of RoA, told us that it “covers the whole balance sheet and, because it is not flattered by leverage, does a better job of adjusting for risk”.¹⁴³⁰

854. Measures such as RoA are attractive because they discourage leverage. However, the use of RoA might incentivise management to underwrite high risk assets. This is because these are likely to bring in a higher return in the short term than a portfolio of the same volume of high quality, lower risk assets. This point was emphasised by the Financial Reporting Council:

Care also needs to be taken when comparing absolute levels of return; higher returns typically imply higher risk and lower returns lower risk. Adjusting returns to take account of relative risks is likely to be appropriate.¹⁴³¹

The point was also stressed by HSBC, who told us that “a return on assets is not risk sensitive so a return on risk weighted assets may be considered more useful”.¹⁴³²

855. The calculation of returns for remuneration purposes depends on the accounting practices used. These returns can be subject to considerable uncertainty, not least because many assets and liabilities on bank balance sheets are long term in nature. There can be a considerable time gap between profits being booked and being realised. This is particularly the case under IFRS accounting, whereby assets are classified as held for trading and therefore marked-to-market values through the profit and loss account. Martin Taylor told us that:

in the bubble, people were using mark-to-market accounting to increase their profits as asset prices rose in the boom and then paying out the unrealised profits in cash.¹⁴³³

856. Assets used for the calculation of profits for remuneration purposes may also be illiquid, with consequently volatile and uncertain values. Andy Haldane explained that:

Under current accounting rules, any fair-value gains or losses flow through automatically to the capital of the bank and, in many cases, the profit and loss of the bank, even if those gains could not in practice be realised—for example, because they are gains on a portfolio of very illiquid assets that you could not prospectively sell.”¹⁴³⁴

Professor Stella Fearnley argued that banks should not be able to use “profits out of financial instruments that are not marked to deep and liquid markets [...] for [...] any form of distribution or bonus payment”.¹⁴³⁵ We consider the case for separate accounts for regulatory purposes in Chapter 9.

1429H Ev 269

1430Bank of England, *Control rights (and wrongs) speech*, Andy Haldane, 24 October 2011

1431H Ev 143

1432H Ev 294

1433Q 2946

1434HQ 103

1435HQq 36-37

Incentives for retail sales

857. Chapter 3 discussed the effect of sales-based incentives on the conduct of retail bank employees, concluding that incentive schemes were a significant factor in mis-selling.¹⁴³⁶ The FSA's September 2012 review of sales incentives found that:

Most firms did not properly identify how their incentive schemes might encourage staff to mis-sell. This suggests they had not sufficiently thought about the risks to their customers or had turned a blind eye to them.¹⁴³⁷

The FSA also found that firms did not understand their own incentive schemes and had inadequate control procedures to monitor their effects.¹⁴³⁸ The FSA published revised guidance in January 2013,¹⁴³⁹ noting that "it remains largely unchanged" but that it had "clarified the wording in some areas and provided more examples of good and bad practice".¹⁴⁴⁰

858. Peter Vicary-Smith called for "an end to the sales-focused culture and the focusing of remuneration on selling rather than providing what customers need."¹⁴⁴¹ During the course of our evidence-taking, several banks have announced that they no longer use sales based incentive schemes to motivate staff in retail branches and call centres. For example, Barclays have adopted a system based on "a measure of customer satisfaction and the extent to which customers would recommend Barclays to others".¹⁴⁴² Lloyds has abandoned quarterly sales targets and now pays quarterly bonuses based on customer feedback.¹⁴⁴³

859. The Remuneration Code requires that "non-financial performance metrics should form a significant part of the performance assessment process"¹⁴⁴⁴ and advocates the use of a "balanced scorecard".¹⁴⁴⁵ RBS outlined its retail scheme:

Payouts are determined on a mix of measures appropriate to each role with the most significant being Customer Service, Branch Contribution and Deposit Balance Growth. All participants must pass risk assessments and customer satisfaction hurdles.¹⁴⁴⁶

1436 See paras 117 – 119.

1437 FSA, *Guidance Consultation: Risks to customers from financial incentives*, September 2012, p 6, www.fsa.gov.uk

1438 *Ibid.*

1439 *Ibid.*

1440 "Risks to customers from financial incentives", FSA press release, FG 13/01, 16 January 2013, www.fsa.gov.uk

1441 AQ 29

1442 "Barclays abolishes commission bonuses for branch staff", *BBC News*, 10 October 2012, www.bbc.co.uk/news

1443 "Lloyds scraps quarterly sales bonuses for bank staff", *The Guardian*, 20 March 2013, www.guardian.co.uk

1444 PRA and FCA, *FSA Handbook*, SYSC 19A, www.fsahandbook.info

1445 FSA, *General guidance on proportionality: The Remuneration Code (SYSC 19A) & Pillar 3 disclosures on remuneration (BIPRU 11)*, September 2012, www.fca.org.uk

1446 Ev 1325

Eric Daniels told us that he had introduced a balanced scorecard to Lloyds TSB in 2001, but this was not effective in preventing widespread mis-selling of PPI by Lloyds.¹⁴⁴⁷

860. Some witnesses told us that, even where formal sales-based incentives have ceased to apply, a culture that values sales appears to have remained. For example, Stuart Davies of the Unite union told us:

Our concern sits around a very, very aggressive sales [and] performance-management culture that exists in the banks, to the extent of e-mail trails that go round and round individual performance on performance targets and whiteboards that contain information on individual performance. That feeds into increased pressure on staff, which feeds into, perhaps, some dysfunctional selling to customers, because they are concerned for their jobs.

The Salz review of Barclays echoed the same issues:

Sales incentives may have gone, but it appears that sales targets still exist at both branch and individual level (either formally or informally). Such contradictions need addressing. If staff see sales targets (such as internal branch league tables) to be important, removing sales based incentive pay may not succeed in changing individual behaviour.¹⁴⁴⁸

Conclusions

861. **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.**

862. **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.**

1447Q 4248

1448Salz review: *An Independent Review of Barclays' Business Practices*, April 2013, para 11.36

863. 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.

864. 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

Deferral

865. The interim Financial Policy Committee has sought to ensure that inappropriately structured remuneration contracts do not increase risks in the banking sector. It noted at its 21 November 2012 meeting how:

the period over which executives' decisions will have an impact on the bank's performance is typically much longer than the period used to judge management performance as reflected in remuneration. In particular, deferral of the long-term incentive component of variable remuneration is typically just three years for the major UK banks' executives, far shorter than the length of the typical business or credit cycle.¹⁴⁴⁹

866. The PRA and FCA's Remuneration Code already states that at least 40 per cent of any variable remuneration must be deferred over a period of not less than three to five years, and that the length of the deferral must be established in accordance with the business cycle, the nature of the business, its risks and the activities of the employee in question.¹⁴⁵⁰

¹⁴⁴⁹Bank of England, *Record of the interim Financial Policy Committee Meeting held on 21 November 2012*, 4 December 2012, para 31, www.bankofengland.co.uk

¹⁴⁵⁰PRA and FCA, *FSA Handbook*, SYSC 19A, www.fsahandbook.info

Michael Cohrs, a former member of the interim FPC, speaking with respect to the length of deferrals, said that:

If you go back a decade the average banker would have been paid a bonus, which was typically cash, which they would put in the bank and go on their merry way. Today, that is not the case [...] the average banker is paid a bonus that typically pays out over three to five year, and it is now typically paid in shares in the company for which the person works.¹⁴⁵¹

However, Mr Cohrs wanted to “go a bit further”, and argued that there was a case for deferral to last seven to ten years to ensure that “we have gone through a business cycle before people are paid out”.¹⁴⁵² Andy Haldane made a similar point:

Typically, those clawback or deferral periods are roughly three to five years. For me, that is far too short to capture the cycle in credit, the cycle in the financial sector. We had roughly a 20-year boom in the run-up to this crisis, so measuring performance only over a three or five-year window is far too short.¹⁴⁵³

Others favoured a deferral period shorter than seven to ten years, but which nevertheless went beyond the minimum three to five years specified in the Remuneration Code. Fidelity Worldwide Investment told us that it had recently changed its proxy voting guidelines so that there was a minimum of five years (up from the previous three years) between the date of grant of an award and the sale of any shares.¹⁴⁵⁴

867. Andrew Bailey saw the deferral as a way of achieving some of the advantages of a partnership structure for banks:

one of the aims in imposing the longer deferral of remuneration is to mimic the sort of partnership structure that would leave, to put it crudely, more skin in the game for longer. That has been a clear objective in creating the economic incentives without having the legal structure.¹⁴⁵⁵

The FSA drew our attention to another argument for longer rather than shorter deferral periods:

the [Remuneration] Code does not require clawback of bonuses that have already been paid or vested, for the reason that there was considered to be less legal certainty over the feasibility of this, although it is an option that has been pursued by firms in some instances. To the extent that this limits the impact of malus in practice, there are arguments for requiring greater or longer deferral.¹⁴⁵⁶

1451EQ 2

1452EQ 5

1453EQ 164

1454Ev 1016

1455Q 4565

1456C Ev 168

Recouping variable remuneration

868. Although the terms ‘clawback’ and ‘malus’ are often used interchangeably, they are different forms of ex-post risk adjustment with potentially different legal and tax consequences. Many bank remuneration schemes give considerable discretion to the relevant remuneration committees to exercise their judgement to reduce outstanding unvested remuneration, including to zero, in the light of subsequent events.

869. ‘Clawback’ is the compulsory repayment of all or some of the cash, shares or other securities previously received by an employee under an incentive arrangement, either because the performance of the business is later found to be worse than initially reported, or because the recipient has committed misconduct which is uncovered after the award is made. As the term strictly refers to the recovery of compensation that has already been received, there are legal and practical obstacles to clawback and limits on when it can be applied. The High Pay Centre has warned that “clawing back money already paid to individuals will be inherently difficult, and may cost as much in legal fees as would be gained from doing it”. Instead, it advocated “smaller variable rewards that would not be paid out until the impact of the action for which the reward was being offered was clearly evident”.¹⁴⁵⁷

870. ‘Malus’ refers to making reductions to deferred performance-related pay in the event of a company’s performance or inappropriate conduct by the employee. Malus arrangements therefore adjust pay or share awards before the employee is entitled to receive the pay or before the share award has vested. The Remuneration Code states that a firm should reduce unvested deferred variable remuneration when as a minimum:

There is reasonable evidence of employee misbehaviour or material error;

The firm or the relevant business unit suffers a material downturn in performance;
or

The firm or the relevant business unit suffers a material failure of risk management.¹⁴⁵⁸

Lord Turner felt that the UK had made “considerable progress” in ensuring that a significant proportion of variable remuneration is deferred and available to be recouped.¹⁴⁵⁹ Andrew Bailey told us that:

What we have seen particularly this year is quite substantial progress in two respects. One is requiring banks to reduce the pools of variable remuneration to reflect redress and fining—but, also, what is technically called malus, where there is effectively a cancellation of previous unvested remuneration.¹⁴⁶⁰

¹⁴⁵⁷Written evidence from the High Pay Centre to the Treasury Committee (CGR 02), May 2012 [not printed], www.parliament.uk/treascom

¹⁴⁵⁸PRA and FCA Handbook, *FSA Handbook*, SYSC 19A, www.fshandbook.info

¹⁴⁵⁹Q 4482

¹⁴⁶⁰Q 4509

871. There are signs that deferred remuneration is being recouped by banks. Lloyds Banking Group has recovered approximately £2 million from 13 senior executives as a result of their role in PPI mis-selling, with the bonus cuts made by reducing the amounts already awarded in deferred shares.¹⁴⁶¹ JP Morgan has signalled its intention to recoup bonuses from the individuals deemed responsible for losses of \$5.8bn (£3.7bn) from trading in complex financial derivatives. This would amount to about two years' worth of pay for each individual.¹⁴⁶² These amounts clawed back are tiny in relation to the losses to the banks as a result of the actions of those involved.

872. Nicholas Dorn of Erasmus Law School told us that a better “collective self-discipline” was required which would encourage “those working in the industry to more closely scrutinise and discipline each other”:

Vertical clawbacks, extended to those who hold line supervisory or management responsibilities, are clearly merited. If superiors claim not to have known, then either they neglected their duties, tactically turned a blind eye or strategically ensured that they were never formally informed. [...]

[Lateral clawbacks] affecting all those within the team, unit and/or bonus pool within which malfeasance occurs (for example, a sales team, prop trading desk or the department within which it sits)—would have the potential to positively incentivise a broader swathe of bank employees to take preventive action. A significant (quite high) level of clawback would be appropriate for those working alongside or near the locus of undesirable behaviour.¹⁴⁶³

873. We noted earlier in this chapter that the practice by which firms buy out the bonus of an employee leaving another firm to join them creates problems for clawing back remuneration based on subsequent financial performance at the employee's former firm. PwC explained:

This has historically provided a ‘retention lock-in’ to support retention of key employees. The FSA Remuneration Code requires that buy-outs are on terms no more favourable than the awards being given up and have performance adjustment applied. But critically the performance adjustment is in the new rather than old organisation. [...] This does create a potential incentive for individuals who see problems emerging to seek to move employment and have their awards bought out to avoid the possibility of claw-back. A radical approach would be to prevent awards being forfeitable on leaving an organisation so that the individual has to live with the full consequences of their actions (including possible claw-back) without the possibility of having those awards bought out.¹⁴⁶⁴

1461 “Lloyds cuts back £2m from bonuses paid to executives”, *BBC News*, 20 February 2012, www.bbc.co.uk/news

1462 JP Morgan & Chase, *CIO Taskforce Update*, 13 July 2012

1463 Ev 948

1464 C Ev 161

The instruments of variable remuneration

874. The variable remuneration of senior executives in the banking sector typically involves being rewarded through shares or share options in the organisation. The growth of share-based variable remuneration was based on the premise that this would serve to align the interests of senior executives with those of shareholders. It has on occasion also had the perverse incentive of encouraging excessive risk-taking and leverage in order to increase the short-term share price, often at the expense of the stability of the firm. The financial crisis has also provided examples of firms, such as Lehman Brothers, where senior executives held large amounts of stock, but where this did not prevent excessive risk-taking or firm failure. Similarly, in the UK, Andy Hornby had invested his entire cash bonus for his final last eight years in HBOS shares.¹⁴⁶⁵

875. Professor Charles Goodhart drew our attention to some alternative instruments of remuneration, including payment in debt instruments and in equity shares subject to additional liability in the event of default.¹⁴⁶⁶ On the former, the FPC has noted that:

remuneration contracts could be better structured to expose executives to the potential downside outcomes over the longer term of the risks they take. The major components of UK banks' executive remuneration are cash and shares. But the Committee notes that incentives could be better aligned to longer-term outcomes if compensation packages were able to include a greater proportion of suitable debt instruments, for example subordinated debt instruments, or debt instruments which carry the potential for bail-in, as recently suggested by the Liikanen Group report.¹⁴⁶⁷

Andy Haldane, a member of the FPC, added:

There is a case for thinking about whether we would not wish to remunerate to a greater degree in debt instruments of various kinds, because then you get less of the upside from gambling and risk-taking, but still suffer the downside in the event of things going wrong. Sometimes the incentives created by paying in shares are every bit as great as the incentives created by paying in cash. Debt or subordinated debt or bail-in debt or Co Cos are ways of adjusting incentives in positive ways.¹⁴⁶⁸

Paul Sharma of the Bank of England told us that the use of bail-in debt would help in “aligning the incentives and solving the principal agency problem not just between the employees and the shareholders, but between the employees and all the stakeholders in the bank”.¹⁴⁶⁹

876. Some witnesses warned, however, that rewarding individuals in debt rather than equity might encourage more risk taking. Fidelity Worldwide Investment argued that:

¹⁴⁶⁵Treasury Committee, Ninth Report of Session 2008–09, *Banking Crisis: reforming corporate governance and pay in the city*, HC 519, para 55

¹⁴⁶⁶Ev 1538

¹⁴⁶⁷Bank of England, *Financial Stability Report*, Issue Number 32, November 2012, p 56-57, www.bankofengland.co.uk

¹⁴⁶⁸Q 166

¹⁴⁶⁹Q 3387

debt carries less risk than equity and is less volatile in its value. By rewarding management through debt instruments one is implicitly encouraging risk with the debt retaining value (and high coupon payments) even in circumstances where the equity may have been wiped out.¹⁴⁷⁰

The Squam Lake Group, a non-partisan group of US-based academics who offer guidance on the reform of financial regulation, have proposed using “holdback” of a significant proportion of senior managers’ remuneration with the aim of preventing the catastrophic consequences of a bank declaring bankruptcy or receiving a government bailout:

we suggest that financial institutions should be forced to withhold a significant share—perhaps one fifth—of each senior manager’s total annual compensation for a significant period—perhaps five years. The deferred compensation would be a fixed ‘dollar’ amount. [...] this compensation would be forfeited if the firm fails or needs government assistance during the holdback period. The holdback is intended to move the incentives of employees who can have a meaningful impact on the survival of the firm closer to those of taxpayers. Because payment is forfeited if the firm stumbles, and does not increase when the firm does well, management would be less inclined to take excessive risk or leverage, and more inclined to recapitalize a distressed firm. Of course, holdbacks only reduce management’s incentives to take excessive risk if management cannot hedge its deferred compensation. Any hedging of deferred compensation should therefore be prohibited.

We argued [...] that managers should forfeit their holdbacks if the firm declares bankruptcy or receives a government bailout. It would be better, however, if the threat of forfeiture pushes management to recapitalize the firm before society is forced to bear all the costs of bankruptcy or government intervention. Thus, we now suggest instead that the threshold for forfeiture of compensation holdbacks should be crossed well before either event is imminent.¹⁴⁷¹

Conclusions and recommendations

Application

877. 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 in accordance with the proposals in Chapter 6.

1470Ev 1017

1471Squam Lake Group, *Aligning Incentives at Systemically Important Financial Institutions*, pp 4-5, www.squamlakegroup.org

Deferred compensation for all senior executive staff

878. 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.

879. 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 effects on behaviour.

The form of deferred remuneration

880. 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.

Length of deferral

881. 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.

Recouping deferred remuneration

882. 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.

883. 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.

Provision in the event of taxpayer bailout

884. 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 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.

Provisions for change of employment

885. 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.

Obstacles

886. 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

887. The role of the bank board was discussed in Chapter 7. The important responsibilities of bank non-executive directors, particularly the Chairman and the Senior Independent Director (SID) were noted. The Commission recommended that the Chairman of a bank board should be full-time and that both the Chairman and the Senior Independent Director should be given specific assigned responsibilities under the Senior Persons Regime. The Commission recognises that these increased responsibilities and time commitments may be reflected in increased remuneration.

888. Customarily, the remuneration of non-executives, including the Chairman, has been fixed and entirely in cash, though many companies set shareholder guidelines e.g. building to a holding equal to annual value of the basic fee.¹⁴⁷² This approach is widely supported by investors. HBOS was a notable exception to this model. Lord Stevenson, the former Chairman of HBOS, was awarded an additional incentive payment equivalent to 100% of his annual fee. The award vested after three years, but was dependent on relative outperformance by the shares over the period, and the ultimate value of the award was also linked to relative and absolute share price performance. HBOS said that it was appropriate for him to have a performance-related long term incentive because he played an “active role in influencing the strategic direction of the Group and ensuring overall performance delivery”.¹⁴⁷³

889. The Walker Review favoured “a very cautious approach to remuneration for NEDs and for the chairman”.¹⁴⁷⁴ It opposed any form of variable remuneration for Chairmen:

There seems no case [...] to depart from the hitherto normal practice of making this a flat fee, without abatement or enhancement for the performance of the business. The chairman’s role is to provide leadership of the board and the entity through the cycle without being overly influenced by short-term developments, whether favourable or unfavourable. The job should reflect this “through cycle” role and the fee should not be fine-tuned on the basis of short-term developments.¹⁴⁷⁵

890. 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.

¹⁴⁷²Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, para 7.44

¹⁴⁷³HBOS, *Annual Report and Accounts 2007: Delivering our strategy*, p 129, www.lloydsbankinggroup.com

¹⁴⁷⁴Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations*, November 2009, para 7.45

¹⁴⁷⁵*Ibid.*, para 7.44

The international dimension

891. Measures taken to reform remuneration in the sector, if taken in isolation by the UK, could result in banks or bankers choosing to locate elsewhere. This implied threat has been a feature of the debate on banking reform in the UK since the financial crisis, and has taken two principal forms. First, that banks themselves might relocate abroad or choose other financial centres when looking to expand their business operations. Second, that bankers themselves might relocate, depriving the UK industry of the talents and the tax revenues of such individuals. These arguments were put forward when the ICB first mooted introducing some form of structural separation, when a bankers' bonus tax was introduced, and most recently following EU proposals for a bonus tax. We have discussed the first of these threats—that institutions might choose to move or expand their business operations outside the UK—in Chapter 4. In this section we consider the possible behaviour of individuals.

892. Sir David Walker told us that “many of the most senior people we [Barclays] have are marketable internationally—that includes the chief executive—and have opportunities elsewhere”. He argued for reforms to remuneration “set by reference to standards internationally”.¹⁴⁷⁶ Andy Haldane thought that changes were best made at European level:

I would hope on this front, actually, that we might ourselves be able to convince the rest of Europe that a somewhat tighter Remuneration Code might be in their interests as well as that of the UK.¹⁴⁷⁷

Michael Cohrs supported practices being set at an international level to avoid regulatory arbitrage:

These should be mandated, and they need to be mandated globally, because if we do not, the banks will create HR centres in countries where regulation perhaps is not quite as rigorous. We must be mindful of that. We have shut down a lot of regulatory arbitrage that used to exist, but we have not shut it all down. Getting these remuneration standards more global and getting agreement with our fellow regulators is quite important.¹⁴⁷⁸

893. The risk of a ‘brain-drain’ of skilled labour if the UK acted alone on remuneration was raised by a number of organisations. The BBA expressed concern that the “UK is becoming an unattractive place in which an individual would choose to spend part of their career”.¹⁴⁷⁹ In response to revisions to the FSA Remuneration Code in 2011, the PA Consulting Group referred to the “clear expectation that the Code will make it more difficult to attract and retain talent in the UK and that this could lead to a loss of competitiveness for the City”.¹⁴⁸⁰ The personal tax regime also been cited as a disincentive to work in the UK. Mark Giddens of UHY Chartered Accountants said that, despite the recent reduction in the top rate of

1476Q 3537

1477EQ 167

1478EQ 5

1479Ev 878

1480“PA Consulting Group and City HR Association publish survey on attitudes towards the FSA Remuneration Code”, PA Consulting group press release, 16 August 2011, www.paconsulting.co.uk

income tax, “a high personal tax burden makes it difficult for the UK to attract and retain the most experienced and skilled workers”.¹⁴⁸¹

894. Individual bankers choosing to leave would need somewhere to go. We argued in Chapter 4 that a mass migration of banking activity from the UK was highly unlikely, and a banker is, of course, nothing without a bank. Many of the factors we identified in that chapter which should continue to make London attractive as a location for banks should also make it attractive to bank employees. There are also more personal factors. A recent report about the quality of life in financial centres for the City of London Corporation said that:

the breadth and depth of London’s cultural offer, its multicultural nature and the diversity of the communities that live and work here [are] aspects seen as desirable and welcoming by international workers considering moving here.¹⁴⁸²

Michael Cohrs put it more succinctly:

London is a pretty neat place to live. These people make a lot of money. They want to spend their money in a pleasant place, and London is a very pleasant place.¹⁴⁸³

895. Andy Haldane stressed the importance of ensuring that the UK had the flexibility under CRD IV to introduce specific remuneration requirements that it deemed necessary to promote financial stability. He noted the scope for “national discretion” in implementing proposals and argued that the UK would be permitted to adopt a more stringent approach to reducing the scope for basing remuneration on non-risk adjusted measures and extending minimum deferral periods beyond three years:

Clearly, any move to impose a tougher line would need to be implemented on a proportionate basis and be consistent with the aims of the Directive. In this case, as the policy is clearly risk-focussed and could be targeted at those senior individuals within a bank with direct responsibility for managing that risk, I believe it would satisfy those criteria.¹⁴⁸⁴

However, he was less confident about the scope for going further than the Directive in terms of the scope for paying bonuses in debt-like instruments as “binding technical standards will be developed that will determine which instruments can be used”.¹⁴⁸⁵

896. 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

1481 “UK tax burden on high earners one of the heaviest in the world”, UHY Hacker Young Chartered Accountants press notice, 5 November 2012, www.uhy-uk.com

1482 Mercer for the City of London Corporation, *Cost of Living and Quality of Life in International Financial Centres*, August 2012, www.cityoflondon.gov.uk

1483EQ 36

1484E Ev 44

1485*ibid.*

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 CRD IV 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.

897. It must be recognised, however, that international agreement on some of the changes we envisage may be neither fast nor 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

A new Remuneration Code

898. In this chapter we have set out a series of reforms to remuneration in the banking sector. Our proposals are designed to ensure that bank staff are aware that there will be financial penalties for failure but, even more importantly, that appropriate behaviour will be rewarded. Remuneration needs to be aligned with the long term interests of the bank and its customers. This means that it must:

- incentivise the company's financial stability as well as its growth;
- incorporate measures of risk, rather than short term revenue and profit;
- particularly in retail and SME markets, where the asymmetry of information is greatest, encourage the marketing of products that are genuinely in customers' long term interests rather than the bank's; and
- allow for clawback or 'malus' in the event of risk or conduct failings.

Overall remuneration structures should also reflect the long term nature of banking.

899. 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.

900. 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.

Transparency and reporting requirements

901. There has been a trend for banking sector remuneration to increase in complexity, particularly for senior executives. Senior executives of major banks now typically receive four elements of remuneration: base salary; benefits, including pension rights, health insurance etc; annual incentives; and Long Term Incentive Plan (LTIP). The annual incentives and LTIP are in turn linked to a range of measures, some of individual performance and some of business units and/or the organisation as a whole. Some of these measures are formulaic, some involve the judgement of the Remuneration Committee.

902. As a result of their complexity, it is often difficult to judge the full value of remuneration packages. The NAPF said in written evidence that “complexity has built up which is now a barrier to understanding and motivation creating perverse behaviour”.¹⁴⁸⁶ Complexity and consequent lack of understanding also limits the ability of shareholders to discipline remuneration. Companies disclose details of how remuneration packages are structured, but not what they believe those packages are worth.

903. This complexity can make it extremely difficult for shareholders, even where they do wish to monitor remuneration arrangements in the banks they have invested in, to do so effectively. This was noted by Virgin Money:

For shareholder discipline to be effective, we suggest that banks should be required to give information about their employee bonus schemes and about bonus payments, for senior executives, investment banking employees and retail banking employees. In parallel, we suggest that there should be greater transparency about their risk exposures and about material changes in their risk exposures, in a written statement that can easily be understood by shareholders.¹⁴⁸⁷

Sir David Walker was supportive in principle of greater transparency:

If it cannot stand the test of daylight and have an explanation to go with it, then there is something wrong in the model. I think that those who believe that if British business generally, which is globally competitive, as much of banking is, needs to pay high rates of pay to be able to recruit high-quality executives, then we have to be able

1486Ev 1262

1487Ev 1423

to win that argument, and winning the argument is not going to be helped by being secretive about it.¹⁴⁸⁸

However, others warned that transparency could have the unintended consequence of further ratcheting up pay. Carol Arrowsmith said:

The biggest single means of ratcheting pay has been the transparency of board pay, because every executive who is worried about pay will have their own database of whom they would like to be paid like. There is absolutely no question but that public disclosure of pay does not reduce pay. It increases it.¹⁴⁸⁹

904. Several witnesses encouraged the disclosure of the number of individuals earning over a threshold figure. They argued that the present requirement only for board member remuneration to be disclosed was perverse, as banks frequently had more highly remunerated staff below board level. Sir David Walker told us:

Bands of remuneration should be published. I proposed bands of remuneration—I think I said £1 million, £2 million, £5 million; how many people were there in those bands.¹⁴⁹⁰

Barclays disclosed the number of employees earning £1m to £2.5m, £2.5m to £5m and over £5m in its 2012 Annual Report.¹⁴⁹¹ Requirements for reporting remuneration under CRD IV are outlined in Annex 6.

905. 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.

906. 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.

1488Q 36

1489Q 3202

1490Q15

1491Barclays, *Annual Report and Accounts 2012*, p 96, www.barclays.com

The role of banks and their owners

907. The question of whether the Government or the regulatory authorities should be involved in regulating or intervening, not just with respect to the structure of remuneration in the banking sector, but also with respect to levels of pay, was raised during our inquiry. The Chancellor, while critical of the level of pay in the sector, argued that it was not the role of Government to address it:

I think that banking and financial services pay has got completely out of kilter with the rest of the economy. It has come down a lot from its highs, but it is still many multiples of what executives in general get. An executive in a pharmaceutical business or in a manufacturing firm would not get the kind of remuneration that you would get in the financial services industry now. I do not want to run a pay policy, because we tried that in this country and it did not work.¹⁴⁹²

908. **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.**

9 Regulatory and supervisory approach

Introduction

909. The failure of regulators to prevent a decline in banking standards is as remarkable as their failure to spot the accumulation of systemic risk and to identify appalling conduct failures, such as the widespread mis-selling of PPI and interest rate swaps, and LIBOR manipulation. The public might be left wondering what purpose was served by almost 4,000 regulatory staff at a cost of around £500m, the bill for which is ultimately footed by the consumer.¹⁴⁹³ Just as astonishing is that, in their evidence to the Commission, the FSA did not identify regulatory failure as a cause of the decline in trust in banks.¹⁴⁹⁴

910. In Chapter 3, we identified one of the underlying causes of the decline in standards and culture in banks to be the instinct of regulators towards process and monitoring compliance on the basis of complex rules. In this chapter we explore the new approach to the regulation and supervision of banks that the recently-established new regulators—the Prudential Regulation Authority and the Financial Conduct Authority—intend to take and consider both the scope and the limits of such regulation to improve banking standards and culture. We consider, in particular, the challenges of the new judgement-based approach, the supervisory relationship with banks and the constraints of the international regulatory environment. We discuss the roles that tax and accounting play in influencing bank incentives, particularly with regards to leverage and valuation of assets, and the need for tax and accounting to align better with the regulatory environment. We also consider how auditors can better support regulatory objectives.

New regulatory architecture

911. Major changes in the UK regulatory architecture came into force on 1 April 2013. These involved the establishment of a new prudential regulator, the Prudential Regulation Authority (PRA), a subsidiary of the Bank of England, and a new conduct regulator, the Financial Conduct Authority (FCA). The PRA will be responsible for prudential supervision while the FCA has responsibility for consumer protection, market integrity, and building competitive financial markets. The reforms have also involved the establishment of the Financial Policy Committee (FPC) within the Bank of England. This new macro-prudential regulator has the task of identifying and addressing systemic risks in the banking sector.

912. The new structure should bring benefits from transferring responsibility for prudential supervision to the central bank. Sir Mervyn King has pointed out: “one of the reasons for putting the PRA inside a central bank is to integrate the work of the two institutions more closely”, which should result not only in more effective supervision but,

¹⁴⁹³FSA, *Annual Report 2011/12*, pp 80 and 119, www.fsa.gov.uk

in longer term, cost savings.¹⁴⁹⁵ We discuss the new regulatory architecture later in this chapter.

Regulatory failure

Introduction

913. The principal responsibility for the failure of the banks lies with the banks themselves, but in the run up to the crisis, regulators around the world failed to clamp down on excessive risk and ensure the banks were resilient enough to survive the storm which came. That such regulatory failures occurred in many different countries suggests it is not a specific regulatory design which is key but instead a regulatory attitude and approach. By the same logic, while regulatory change is necessary in the wake of the crisis, it would be a mistake to assume that rearranging the regulatory pieces in any individual country will on its own make a huge difference unless regulatory attitudes also change.

914. The regulatory failures of the past decade were catastrophic. The failure by prudential supervisors to ensure that banks had adequate capital, liquidity, and asset quality contributed to the financial crisis and the bank bailouts that cost the taxpayer huge sums of money. Failings in conduct supervision allowed serious misconduct, including the widespread mis-selling of PPI and LIBOR manipulation to continue undetected or unchallenged for a long period of time.

915. The FSA pointed out in their Report, *The Failure of the Royal Bank of Scotland*, that failings were the result, in part, of a “light-touch” approach to regulation which arose from “a sustained political emphasis on the need for the FSA to be ‘light touch’ in its approach and mindful of London’s competitive position.”¹⁴⁹⁶ That same report identified deeper failings, both to look at the right issues and to draw lessons from the issues they did examine, which can be summarised as a neglect of prudential risk and putting form before substance in conduct regulation.

Shortcomings of prudential regulation and supervision

916. Evidence suggests that in the period preceding the financial crisis, the FSA failed to focus sufficiently on substantive prudential issues.¹⁴⁹⁷ Lord Turner told us:

I would accept that on the prudential side we clearly diverted from a true interpretation of a risk-based approach. On the prudential side, three things matter: capital, liquidity and asset quality. This is the absolute core of what prudential supervision is about. If you look at what we were doing on RBS and HBOS at that time, there was not enough focus.¹⁴⁹⁸

¹⁴⁹⁵Speech by Sir Mervyn King at the Lord Mayor’s dinner for bankers and merchants of the City of London, Mansion House, London, 15 June 2011

¹⁴⁹⁶FSA Board Report, *The Failure of the Royal Bank of Scotland*, December 2011, p 254

¹⁴⁹⁷*Ibid.*, p 269

¹⁴⁹⁸Q 4419

Andrew Bailey told the Treasury Committee:

the FSA [...] found it very difficult to achieve a stable balance between prudential and conduct priorities.¹⁴⁹⁹

Prudential risk issues appeared to be scarcely on the FSA Board's radar screen. According to the FSA's Report, *The Failure of the Royal Bank of Scotland*, an analysis of the FSA's Board minutes during the 19 months prior to the financial crisis showed that of the major topics discussed, only one out of 61 related in some way to bank prudential risks, just one out of 110 items reported to the FSA Board within the CEO's report were prudential issues, and of 229 items reported by the Managing Director of Retail Markets to the Board, only five were prudential issues.¹⁵⁰⁰

917. In their report into the failure of RBS, the FSA accepted that prudential supervisors did not sufficiently assess and challenge key strategic decisions and business model risks.¹⁵⁰¹ As a result, banks were able to adopt aggressive growth strategies aimed at maximising short term profits. Sir Mervyn King argued in a speech in 2011:

It did not take complex reporting to see that the balance sheet of the banking system nearly trebled in five years, or that leverage ratios had reached levels of 50 or more. The obsession with detail was in fact a hindrance to seeing the big picture.¹⁵⁰²

We were also told that the FSA's immediate response to the financial crisis did not address the failure to focus on major risk issues. A major UK bank told us:

in the immediate aftermath of the crisis and the bank failures in the UK, the FSA reacted by introducing a multitude of new rules and reporting requirements.¹⁵⁰³

Andrew Bailey told the Treasury Committee:

The FSA began a programme of "intensive and intrusive" prudential supervision. This had some successes in rectifying the pre-crisis failings of not concentrating sufficiently on prudential supervision, but such a process can lead to extremely detailed work.¹⁵⁰⁴

This view was echoed by a bank, which told us that:

In the rush to correct the flaws in the existing regulatory framework there has been insufficient prioritisation of regulatory changes, inadequate focus on the interaction between different sets of changes, and too much emphasis on new rules rather than better supervision.¹⁵⁰⁵

1499Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 13, www.bankofengland.co.uk

1500FSA Board Report, *The failure of the Royal Bank of Scotland*, December 2011, p 264

1501*Ibid.* p 253

1502Speech by Sir Mervyn King at the Lord Mayor's dinner for bankers and merchants of the City of London, Mansion House, London, 15 June 2011

1503Letter to the Commission from a UK bank [not published]

1504Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 10, www.bankofengland.co.uk

1505Letter to the Commission from a UK bank [not published]

Dangerous global distractions

918. The international prudential regulations in the run up to the financial crisis, implemented under the Basel II accord, were deeply flawed, resulting in lower levels of regulatory capital held by banks. Carol Sergeant, former CRO, Lloyds Banking Group, told us:

if you used your internal model to derive the capital requirement, you typically ended up with a lower level of capital, so there was an enormous incentive, then that just took off mightily. You can see from the aggregate statistics that the amount of capital held in the banking system, relative to the volumes of business written and the risk-taking, just got smaller and smaller.¹⁵⁰⁶

Andy Haldane told us that by allowing banks to use their own internal models to calculate risk weightings of assets:

we were asking people to mark their own examination papers. The consequences of that have been in some ways entirely predictable. We have seen banks holding progressively less capital against their exposures.¹⁵⁰⁷

919. Martin Taylor described to us how the introduction of international regulations under Basel accords encouraged regulators to hide behind rules and cease to apply regulatory judgement:

One of the things that went wrong of course was that the regulators stopped having a view on capital requirements. They outsourced it all to the Basel rules[...] everything went to the automaticity of Basel I and then Basel II, where people were free, if they wanted to, to game the system. It was very easy to hold less regulatory capital than you perhaps really needed to hold—you were following the rules, but you were not being especially sensible.¹⁵⁰⁸

Not only was the design of Basel II flawed but the process of approving banks' internal models proved an enormous distraction from routine supervisory work. Carol Sergeant told us that:

They made it very difficult for themselves to see the wood for the trees. They [...] used up a huge amount of their energy and capacity dealing with all these models, and I suspect that they did not have enough time left over to go and do the common sense tyre-kicking.¹⁵⁰⁹

Michael Foot, former Managing Director of the FSA, described Basel II as “immensely complex and immensely resource-demanding” and “a complete waste of time”.¹⁵¹⁰ The distraction proved catastrophic, as regulators failed to focus on the real risks emerging within banks in the critical areas of asset quality and liquidity. Carol Sergeant told us:

1506EQ 93

1507EQ 155

1508Q 384

1509EQ 99

1510BQ 1074

I was very concerned because people were not coming in just looking at the basics, for example, of how our credit risk was run or how our liquidity was managed [...], I got in touch with colleagues at the FSA and said, “You are sending in junior technicians who are having a jolly interesting intellectual debate about what is going on in the bottom left-hand corner of a model, but nobody is coming in and taking a thoroughly good view of how we are managing credit”.¹⁵¹¹

920. The regulators paid insufficient attention to emerging funding and liquidity risks as banks increasingly funded themselves through short term interbank funding, while failing to hold a sufficient level of liquid assets. Michael Foot recalled:

when I started at the Bank of England, the liquidity requirement was simple: 30 per cent of assets were to be held in liquid form. By about 2007, I believe, on the same basis of calculation, that number would have been down to about 4 per cent¹⁵¹²

As noted in our Fourth Report into the failure of HBOS, Clive Briault, former Managing Director, FSA, considered that one of the reasons for deficiencies in the framework for monitoring liquidity risk was that the FSA was under pressure from banks to wait for global liquidity regulations to be developed.¹⁵¹³ There was also an absence of forward-looking stress testing of liquidity scenarios, which, according to evidence taken during our review of HBOS appears only to have become a focus of attention for the FSA in late 2007, when they wrote to the bank to request stress tests to be performed.¹⁵¹⁴ This was a case of far too little too late.

Conduct failings: missing the bigger picture

921. The FSA’s approach to conduct supervision focused primarily on implementation of its Treating Customers Fairly initiative, which was one of two priorities for the regulator in the period preceding the financial crisis (the other being Basel II implementation).¹⁵¹⁵ It is to be noted that when statutory regulation came in under the FSA, the Banking Code Standards Board, a self-regulatory body of the banking industry, remained in place with responsibility for monitoring and enforcing standards covering deposits, current accounts, savings, personal loans, credit cards and ATMs. These were only taken over by the FSA in September 2009.¹⁵¹⁶

922. In January 2005, the sale of PPI (along with other general insurance) was added to the FSA’s statutory remit, which required the FSA to regulate the conduct of around 20,000 new firms.¹⁵¹⁷ Despite its prioritisation of Treating Customers Fairly, the FSA failed to protect consumers from the mis-selling of PPI, which Carol Sergeant described as “a

1511EQ 92

1512BQ 1046

1513B Ev 179–180

1514B Ev 531

1515FSA Board Report, *The failure of the Royal Bank of Scotland*, December 2011, p 269

1516FSA, *The Banking Conduct Regime*, www.fsa.gov.uk

1517 “All systems go as ‘GI-Day’ arrives”, FSA Press Release FSA/PN/003/2005, 14 January 2005, www.fsa.gov.uk

massive regulatory failure”.¹⁵¹⁸ The FSA admitted that in this case it did not consider a wider perspective, which led to a failure to assess the problem properly:

The FSA lacked the capability to do market wide analysis which could have informed our thematic work.¹⁵¹⁹

The response of the FSA to mis-selling was the creation of more rules. Eric Daniels, former Chief Executive, Lloyds Banking Group noted that:

in 2005, we had 173 new rules that were asked for in ICOB [...]. With each thematic review came more changes.¹⁵²⁰

Gordon Pell, former Chairman, Retail Banking and Wealth Management, and Chief Executive, Retail Markets, RBS, told us:

It actually got down to, “This box ought to be this size, rather than this size.” I think a lot of this could have been changed if someone had come in '05 and said, “We don’t need to go through any of that. We think, as a matter of principle 6, this is treating customers unfairly. Please explain yourselves.”¹⁵²¹

However, this attitude shows that major banks had effectively outsourced how to treat their customers and their responsibilities to the regulator. It is irresponsible for senior executives to seek to deny responsibility by blaming the regulator for not stopping the poor practice and unfair treatment over which they presided.

923. The Financial Ombudsman Service (FOS) wrote to the FSA to point out that their response, which centred around individual customer complaints, was not appropriate given the scale of the problem. Natalie Ceeney, Chief Executive of the FOS, told us:

what we were proactively calling for was to move away from the idea that every individual had to complain, because the scale was so great in 2008 [...] One of our big disappointments was that that advice was unheeded. We are now in a situation in which 50 million PPI policies have been sold and we are just waiting for everyone to complain, and that still does not feel like the right answer.¹⁵²²

924. Deficiencies in conduct supervision were also evident in the failure by the FSA to identify widespread LIBOR manipulation or to hold individuals to account for these failings, as we discuss in Chapter 10.

Mired in process

925. As noted earlier, conduct and prudential supervisors failed to focus on major risks and instead spent their time implementing processes and monitoring compliance against rules and detailed risk mitigation plans. Alistair Clark, a former member of the Bank of

1518EQ 111

1519J Ev 255

1520Q 4247

1521JQ 455

1522JQ 691

England's interim FPC, has described this as a supervisory approach that "relied too heavily on detailed rules and did not require, or give enough room for, the exercise of judgement".¹⁵²³ In written evidence, a major UK bank told us:

The mix of regulated firms from the globally systemic, to small branches of overseas banks to the tens of thousands of IFAs, meant that a great deal of the work was process driven rather than big picture judgement.¹⁵²⁴

Sir Mervyn King has explained that such an approach does not support financial stability:

Process—more reporting, more regulators, more committees—does not lead to a safer banking system.¹⁵²⁵

926. At the heart of the FSA's processes for both prudential and conduct supervision was the risk assessment framework known as ARROW.¹⁵²⁶ ARROW assessments were extremely resource intensive both for the supervisors and the supervised bank. They involved numerous meetings. One bank told us that ARROW visits involved around 130 interviews.¹⁵²⁷ The output from the process was an overall assessment of both conduct and prudential risks and a Risk Mitigation Plan (RMP) which listed detailed issues to be addressed by the bank.¹⁵²⁸ We were told that supervisors adopted a box ticking approach to monitoring a bank's progress in implementing RMP actions. Peter Cummings, former CEO, Corporate Division at HBOS, told us:

the bizarre thing is that I tell them what I am doing and it gets fed back to me as 'this is what we want you to do' [...] If they see me doing something about advance portfolio management, that is a tick in the box. If they see me doing something about a programme or a project about operational risk, and I set up a project management team to manage the operational risk project, and so on, that is a tick in the box for them.^{1529, 1530}

927. Andrew Bailey has suggested that a tick-box culture amongst regulators meant that so long as firms complied with the rules, they were allowed to continue with practices that led to poor standards.¹⁵³¹ Furthermore, witnesses suggested that an emphasis on rules may have encouraged gaming by banks. Michael Cohrs told us:

1523Bank of England, *What is the FPC for? speech*, Alastair Clark, 24 May 2012,

1524Letter to the Commission from a UK bank [not published].

1525Speech by Sir Mervyn King at the Lord Mayor's dinner for bankers and merchants of the City of London, Mansion House, London, 15 June 2011

1526FSA Board Report, *The failure of the Royal Bank of Scotland*, p 256

1527Letter to the Commission from a UK bank [not published]

1528FSA Board Report, *The failure of the Royal Bank of Scotland*, p 256

1529BQ 1353

1530BQ 1354

1531Bank of England, *The challenges in assessing capital requirements for banks speech*, Andrew Bailey, 6 November 2012, www.bankofengland.co.uk

I think I can take any rule and, given enough time, there would be a way around it, or I could show you how banks, in the past, have gotten around it. It does not matter how simple the rule is.¹⁵³²

The wrong level of engagement with banks

928. As was evident from our Fourth Report, the FSA’s engagement with banks, even at Board level, suffered from an approach that devolved too much of the relationship to junior staff. Even for large complex banks, substantial responsibility was devolved to junior and inexperienced FSA staff.¹⁵³³ Carol Sergeant, told us that:

in the lead-up to the crisis, we were being dealt with by very junior people. The senior management at the FSA never really darkened our door and, frankly, only when we actually asked them to come. So we would have an extraordinarily junior person who would come and present to the board and who really could not cope with the kind of challenges and questions that came from the board.¹⁵³⁴

When asked what the senior people at the FSA were doing, Ms Sergeant responded: “I have no idea.”¹⁵³⁵

Quality of supervisory staff

929. Witnesses also suggested that the FSA suffered from insufficient expertise amongst its supervisory staff. Carol Sergeant said that she had dealt with “extremely inexperienced people.”¹⁵³⁶ A former bank supervisor at the Bank of England said that at the point of the transfer of banking supervision from the Bank of England to the FSA in the late 1990s, there had been a hollowing out of supervisory expertise resulting from a decision to “let go, before the transfer to the FSA, supervisors reaching or over 50 years of age”.¹⁵³⁷

930. A major bank suggested that the FSA had trouble attracting talented staff because it did not have the long tradition and status to be able to attract and retain the same depth of staff talent as the Bank and the Treasury, who were able to attract the brightest and the best “in part because of their status in society and their heritage and also because of the opportunity to work on the big issues impacting the UK”.¹⁵³⁸ Furthermore, they told us that a focus by the FSA on consumer issues in its early years “would have been less interesting to those attracted to working on broader policy issues”.¹⁵³⁹

1532EQ 22

1533Fourth Report, para 80

1534EQ 107

1535EQ 108

1536EQ 107

1537B Ev 252

1538Letter to the Commission from a UK bank [not published].

1539*ibid.*

Conclusions

931. The primary responsibility for banking standards failures must lie with those running the banks. However, the scale and breadth of regulatory failure was also shocking. International capital requirements led to the FSA becoming mired in the process of approving banks' internal models to the detriment of spotting what was going on in the real business. Many of the FSA's failings were shared by regulators of other countries. However, this does not absolve UK regulators from blame. They neglected prudential supervision in favour of a focus on detailed conduct matters. Along with many others, including accountancy firms and credit ratings agencies, the FSA left the UK poorly protected from systemic risk. Multiple scandals also reflect their failure to regulate conduct effectively.

932. The FCA and PRA are new organisations. They have each set out their aspirations for a new approach. This is welcome. Whether they meet those aspirations, or whether they repeat mistakes of the past, remains to be seen. The Commission recommends that the Treasury Committee undertake an inquiry in three years' time into the supervisory and regulatory approach of the new regulators.

Real-time supervision

Introduction

933. The Financial Services and Markets Act 2000 (FSMA) establishes an overarching framework for UK financial services legislation and regulation. It gives powers to the Treasury to make secondary legislation and gives the FCA and the PRA powers to make rules and guidance for firms within the scope of the FSMA regulatory regime. As part of the recent regulatory reforms, FSMA has been amended through the Financial Services Act 2012. FSMA sets out the high level 'Threshold Conditions' that banks must meet at all times in order to be permitted to carry out regulated activities.¹⁵⁴⁰ The PRA and FCA have regard to a number of 'regulatory principles' set out in FSMA. The PRA has set out its approach to supervision in its *Approach to Banking Supervision* publication¹⁵⁴¹, and the FCA has outlined its approach in its *Journey to the FCA*.¹⁵⁴²

1540PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 8

1541*Ibid.*

1542FSA, *Journey to the FCA*, October 2012, www.fsa.gov.uk

Box 16: Principles and rules in regulation

The now defunct FSA was widely criticised for adopting a box-ticking approach to regulation based on countless rules rather than exercising judgement based on overarching principles.¹⁵⁴³

The new regulators have pledged to adopt a new approach. The FCA's *Industry Guidance* states that it is "committed to making a decisive shift towards more principles-based regulation, including making the regulatory architecture more principles-based, with greater emphasis on high-level and outcome-focused rules".¹⁵⁴⁴ Similarly, Andrew Bailey described the new PRA approach as one where "supervisors concentrate on the biggest risks to our statutory objectives posed by the firm, rather than pursuing a myriad of issues that in some cases resulted in the FSA being more like an internal audit function than a regulator".¹⁵⁴⁵

However, pledges to move away from box-ticking are nothing new. At the FSA's formal launch in November 2001, its then Chairman, Sir Howard Davies, said:

"We need to alter the way we deal with firms. We don't want—and they don't want—a box checking routine. Our risk-based approach should ensure that in future, when we visit a firm we have a clear purpose in doing so."¹⁵⁴⁶

Julia Black wrote that, at least in theory, "The use of Principles, rather than reliance solely on more detailed and prescriptive rules, has been a feature of the regulatory regime for financial services since 1990".¹⁵⁴⁷

934. Both regulators intend to adopt a judgement-based approach in future. The scale of the change in approach that is needed to deliver judgement-based supervision should not be underestimated. We asked for written evidence from banks on the approach of the regulators. Taken together, their evidence gives us pause for thought. Although our evidence was collected prior to the formal creation of the FCA and PRA, the FSA had at that point adopted an internal structure under which it was operating prudential and conduct supervision from within separate parts of the organisation (the Prudential Business Unit (PBU)) and Conduct Business Unit (CBU)). Banks appeared to be concerned that old habits persist. A major UK bank told us that it would encourage the new regulators:

to devote more effort to understanding the big strategic goals of the organisation, rather than focussing on the micro level details. Many meetings are scheduled which focus mainly on the latter.¹⁵⁴⁸

¹⁵⁴³For example see, Treasury Committee, Twenty-Sixth Report of 2010–12, *Financial Conduct Authority*, HC 1574

¹⁵⁴⁴FCA, *Industry guidance*, www.fca.org.uk

¹⁵⁴⁵Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 10, www.bankofengland.co.uk

¹⁵⁴⁶FSA, Speech by Sir Howard Davies to the Foreign Banks and Securities Houses Association Conference, 29 November 2001

¹⁵⁴⁷Julia Black, "Making a Success of Principles-Based Regulation", *Law and Financial Markets Review*, vol 1, issue 3 (2007), p192

¹⁵⁴⁸Letter to the Commission from a UK bank [not published].

PRA's supervisory approach

935. The PRA has stated its intention to adopt a judgement-based approach to supervision, focusing on major risks to their objectives. The PRA explains that its approach:

relies significantly on judgement. [...], in particular, supervisors need to decide which risks are the most material and must be pursued. A judgement-based approach is necessary in a forward-looking regime, where the future state of the world is inherently uncertain.¹⁵⁴⁹

To support this new judgement-based approach, the PRA has developed a risk framework, illustrated below. There will be three key elements to the framework. First, supervisors will assess the potential impact of a firm, both in the event of failure, and the potential for firm failure to cause disruption to critical financial services, and through ensuring that the firm's behaviour does not contribute to stress in the financial system through risky behaviour. Second, supervisors will assess risks to the firm arising from the external environment in which it operates and risks arising from its business model. Finally, it will assess the strength of mitigating factors which offset risks posed to the firm, such as the effectiveness of management and governance; risk controls; and the adequacy of capital and liquidity. The supervisors will take account of the resolvability of a firm. Assessments will be aimed at identifying the major risks to the firm. Firms will be subject to assessment work on a continuous cycle, with the PRA regularly updating its overall view of a firm, the risks it faces and the risks it poses. The frequency and intensity of the PRA's work will increase in line with a firm's potential to create disruption to the wider financial system in the event of failure.¹⁵⁵⁰ The PRA will not operate a zero failure regime.

The PRA's risk framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation	Structural mitigation	
Potential impact	External context	Business risk	Management and governance	Risk management and controls	Capital	Liquidity	Resolvability

Source: Bank of England, *The Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p12

936. In reaching judgements, the PRA intends to be forward-looking, meaning that it will apply stress tests based on plausible and extreme scenarios. The PRA recognises that its judgements will sometimes be wrong. This may particularly be the case if judgements are made about events whose outcomes are uncertain or that are yet to happen. The PRA's *Approach to Banking Supervision* document notes that:

The PRA's supervisory judgements are based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's

¹⁵⁴⁹PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 12

¹⁵⁵⁰*Ibid.*

judgement will be at variance with that of the firm. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong.¹⁵⁵¹

937. In its Report, *The FSA's Report into the Failure of RBS*, the Treasury Committee noted that the PRA's use of judgement-based regulation in the future could, at times, lead to the appearance that the PRA was acting as a shadow director and raised an expectation that the PRA examine how it will minimise this risk and publish its findings.¹⁵⁵² John Kay has cautioned against supervisors acting as shadow managers, arguing:

Supervision involves a form of shadow management; but it is almost inevitable – and wholly inevitable in the financial services industry – that shadow management will be at a disadvantage to the real management in terms of the competence of its staff and the quality of information available to it.¹⁵⁵³

A joint response from both regulators to the Treasury Committee's Report stated that:

In carrying out our responsibilities we consider that, as long as we act properly within our statutory functions, the Court[s] should not classify either the PRA or FCA as a shadow director of regulated firms.¹⁵⁵⁴

The response further drew attention to the PRA's statement in its *Approach to Banking Supervision* document that the responsibility for running a bank rests firmly with its management and board, stating:

[...]it is the responsibility of each firm's board and management to manage the firm prudently, consistent with its safety and soundness, thereby contributing to the continued stability of the financial system.¹⁵⁵⁵

938. An example of how judgement-based supervision will be applied is in the assessment of a bank's asset quality, including its approach to asset valuations. Appropriate asset valuations are important in determining the adequacy of a bank's capital (which needs to be able to absorb losses arising from a deterioration in asset values). They are also important for assessing liquidity, where the realistic valuation of assets held in a bank's treasury portfolio is necessary for ensuring that the bank is able to raise sufficient cash when required to meet obligations. One of the deficiencies in prudential regulation in the lead up to the financial crisis was a failure to ensure that asset valuations were appropriate. This proved to be a particular problem for certain asset classes, such as portfolios of commercial loans, and in relation to asset backed securities, where there was a failure to understand the inherent risks in the product. In our Fourth Report we noted how one of the FSA staff responsible for HBOS told us that the FSA's approach was one: "that was nowhere near sufficient to be able to get to grips with the actual quality of the underlying

1551PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 5

1552Treasury Committee, Fifth Report of Session 2012–13, *The FSA's Report into the failure of RBS*, HC 640, para 26

1553John Kay, *Narrow Banking: The Reform of Banking Regulation*, p 33, www.johnkay.com

1554Response from the PRA and FCA to the Treasury Committee's Fifth Report of Session 2012–13, June 2013

1555PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 20

assets within the book.”¹⁵⁵⁶ A failure to adopt a forward looking approach to asset valuations was reflected in inadequate stress testing. Michael Foot told us:

by the time you got to the end of 2008, I suspect that the stress testing that the FSA were requiring of their firms pretty well included the end of the universe, which was good, but before that they were not doing so. They were in a paradigm that said, "We have all this value-at-risk data and we have this experience of this, that and the other; let's stress the housing market by watching prices fall by 20 per cent or whatever." Actually, when things went wrong, they went wrong in a much worse way, partly because everybody-regulators included-underestimated the extent to which asset classes were correlated.¹⁵⁵⁷

939. The PRA intends to take a more pro-active approach to asset valuations. The *PRA's Approach to Banking Supervision* notes that:

forward-looking stress testing, tailored to firms' particular risks, plays an important part in the PRA's judgements about a firm's financial soundness in the presence of inevitable uncertainty about future risks. Stress tests cover the quality of lending portfolios, the robustness of asset valuations and provisions and the liquidity and valuations of trading portfolios.¹⁵⁵⁸

Andy Haldane suggested to us that one approach that supervisors could take to the valuation of assets would be to conduct spot checks on assets to see if they are behaving in the way expected:

I am attracted to the idea of what you might call a spot-check approach to supervision and regulation, which is not to have an army of regulators and supervisors peering down every rabbit hole, looking for problems, but instead to pick an asset [...] at random, through a spot check, and assess whether it is doing all that it says on the tin.¹⁵⁵⁹

940. If the regulators find deficiencies in valuations of certain assets classes, they will need to ensure that the bank takes remedial action. They may heighten the intensity of supervision through, for example, additional capital requirements or restrictions on the business until deficiencies have been addressed. In the event of a failure to take proper remedial action, the regulator may take enforcement action against the firm or individuals. As we explained in Chapter 6, the Commission is proposing that a Senior Person will be held responsible for each risk area in a bank. The appropriate person will be held responsible for addressing any deficiencies in the approach to valuations. For example, if these are in treasury asset valuations, the Treasurer may be liable.

941. The Commission welcomes the PRA's stated aspiration to pursue a forward-looking approach to the assessment of banks' capital and liquidity adequacy, including by assessing the adequacy of asset valuations. In exercising judgement in real time,

1556BQ 1421

1557EQ 79

1558PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 26

1559EQ 171

regulators will need to steer a course which ensures that they do not assume a position as shadow directors and should bear in mind that it is the directors of banks, and not the regulators, who are answerable to shareholders. The regulators have acknowledged that their judgements will sometimes be wrong. They will need to accept that bankers will make wrong judgements too. It will be important that supervisory judgements are made in real time and not based on a view taken with the benefit of hindsight. Account will need to be taken of the information reasonably available to banks at the time decisions were taken. Banks are in the business of taking risk and regulators should not create an atmosphere in which normal operations become stifled because of fear of regulatory actions in years ahead. However, the mere fact that the regulator did not identify a risk will not necessarily absolve individuals in banks from responsibility.

942. The Treasury Committee asked the PRA to examine how it will minimise the risk of appearing to act as shadow directors under their new approach to regulation, and to publish its findings. It asked the same of the FCA. Something more substantial than the assurances given to date is required. The regulators should publish a further considered response to the risk that they may appear to be acting as shadow directors. They will need to do so in the light of recommendations elsewhere in this Report and other reforms already in train. The Commission recommends that the regulators report to the Treasury Committee within six months. The Commission further recommends that the Treasury Committee, in its inquiry on the supervisory approach of the regulators, take further evidence on this issue.

FCA's supervisory approach

943. In its *Journey to the FCA*, the FCA states that:

The new approach will be underpinned by judgement-based supervision. This means that we will be making supervisory judgements about a firm's business model and forward looking strategy, and will intervene if we see unacceptable risks to the fair treatment of customers.

In order to assess conduct risks, the FCA has replaced the failed ARROW framework with a Firm Systemic Framework (FSF). Through the FSF it will “assess how firms manage the risks they create and identify the root causes of what leads to these risks”. It will also seek to understand consumers' actual experiences of dealing with firms. The assessment will draw on business model analysis to identify the key issues which firms need to address.¹⁵⁶⁰ As with the old ARROW approach, the assessment will take place through interviews between supervisors and the firm, and will result in a letter sent to banks identifying the key risks and accompanied by a risk mitigation programme. According to the *Journey to the FCA* document, there will be some differences between the FSF and ARROW (such as prioritisation of actions by the firm and fewer risk mitigation points), but the extent to which the old ARROW approach has been truly jettisoned remains unclear.

¹⁵⁶⁰FSA, *Journey to the FCA*, October 2012, p 28, www.fsa.gov.uk

944. Evidence suggests that changing approach to a new, judgement-based approach may prove challenging for the FCA. One of the challenges will be to move away from collecting and analysing large quantities of low level data. Douglas Flint told us:

There is still a tremendous amount of data capture, which is incredibly low-level detail. I hope that as we get into the new regime we can use a much more interactive relationship to get to the forest and away from the twigs on the branches of the trees.¹⁵⁶¹

Effective data gathering appears to be a particular challenge for the conduct regulator. Commenting on data gathering under the arrangements established by the FSA for prudential and conduct regulation before the formal transition to the new regulatory structure, one bank told us:

our experience is that the Prudential Business Unit is now making good progress on scoping information requests and channelling them through the Supervision team. We look forward to the Conduct Business Unit taking a similarly business focused approach.¹⁵⁶²

Another bank told us:

There is evidence that the number and volume of requests has increased considerably and this is particularly in the context of the Conduct Business Unit at the FSA. Clearly there is an emerging agenda, as described in the “Journey to the FCA” document and this coupled with a higher frequency of idiosyncratic and thematic visits and information request has contributed to the increase. We expect the frequency of requests to increase.¹⁵⁶³

945. A further challenge that makes the analysis of data more difficult is the weak IT systems that the FCA has inherited from the FSA. The FCA has noted the need for significant investment in its IT capability in its 2013/14 Business Plan, without which, there is an increasing risk that its systems will not be fit for purpose to enable it to meet its statutory objectives.¹⁵⁶⁴

946. The FCA is housed in the same building as the former FSA, has many of the same staff, and many of the same systems as the FSA. These continuities will make the transfer to a new judgement-based approach more difficult for the FCA than for the PRA. Other challenges arise from the need to move away from gathering vast quantities of data and low-level analysis. The FCA should ensure that all data requests have a clearly articulated purpose. The Commission recommends that the Treasury Committee, when undertaking its inquiry into the supervisory approach of both regulators, assess whether the FCA’s approach to data collection has been appropriate. Given that banks have been given notice of this inquiry, any complaints by them about

¹⁵⁶¹Q 3848

¹⁵⁶²Letter to the Commission from a UK bank [not published].

¹⁵⁶³*Ibid.*

¹⁵⁶⁴FCA, *Business Plan 2013/14*, 25 March 2013, p 49, www.fca.org.uk

excessive data collection would need to be supported by evidence. It is not enough to complain only in private.

Products supervision

947. The FCA will have new, more wide-ranging powers to intervene in financial products under the Financial Services Act 2012. These include the mandate to make rules to ban products that pose unacceptable risks to consumers, subject to consultation, and to make temporary product intervention rules where the delay involved in consultation would prejudice consumer interests.¹⁵⁶⁵ Jon Pain described these as “a fairly powerful series of tools to deploy.”¹⁵⁶⁶

948. Some remarks made by successive Chief Executives of the FCA and its predecessor body, the FSA, are unlikely to encourage constructive engagement with the regulated community, widely held to be much-needed, as discussed further below. In the aftermath of the financial crisis, Hector Sants is reported as saying:

There is a view that people are not frightened of the FSA [...] I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA.¹⁵⁶⁷

More recently, Martin Wheatley has reinforced this view, stating that the FCA is “being given the power to shoot first and ask questions later.”¹⁵⁶⁸ There are risks in such an approach, not only to the relationship between regulators and firms but also in that it may discourage banks from innovating in new products, to the detriment of consumers. Andy Haldane told us:

It is important [...] not to overshoot. We would not want to put ourselves in a position in which banks were sufficiently scared and scarred not to wish to innovate—to bring new financial products—for fear of, ultimately, being caught out down the road for having produced something that is not quite doing what it says on the tin.¹⁵⁶⁹

949. Although the FCA will have powers to intervene in products, it will not pre-approve products. According to the *Journey to the FCA* document, this would “require a marked increase in regulatory resources” and “it could also lead consumers to assume that all products had been endorsed by the regulator were therefore ‘safe’.”¹⁵⁷⁰ Some witnesses felt that a form of kite-marking would, however, be desirable to remove the risk of judgements being made about a product’s suitability by the regulator. Douglas Flint told us:

¹⁵⁶⁵FSA, *Journey to the FCA*, October 2012, p 14, www.fsa.gov.uk

¹⁵⁶⁶JQ 202

¹⁵⁶⁷“‘Be afraid’ warns regulator Sants”, *BBC*, 12 March 2009, www.bbc.co.uk/news

¹⁵⁶⁸“Martin Wheatley: FCA will ‘shoot first and ask questions later’”, *Money Marketing*, 18 September 2012, www.moneymarketing.co.uk

¹⁵⁶⁹Q 632

¹⁵⁷⁰FSA, *Journey to the FCA*, October 2012, p 14, www.fsa.gov.uk

some kind of product regulation that creates kitemark products is worthy of exploration. There needs to be some kind of safe harbour. If a product has been designed to a regulatory-approved specification and if the sales standards and practices designed for that product are followed, in terms of identifying to whom it should be sold and how it should be sold, there ought to be a confident belief that that works. The industry deals with situations where it has been challenged that it has failed in its sales practices over a long period of time. We have to try and find a way for our own, and society's, protection to get to these issues earlier, and the public can be confident that we have a suite of products that do what they say on the tin.¹⁵⁷¹

Asked whether kite-marking was about providing a safe harbour from the perspective of the firm or the consumer, Stuart Gulliver told us:

From both. We have to think, "What in 2023 that we sold today in 2013 will be deemed to have been inappropriate?" That leads to all sorts of issues around financial exclusion, if you think about it, because it means firms back away. We hope that the FCA can provide kitemark-stamped products that, yes, protect the industry, because they protect the consumer and cannot be unpeeled in 10 years' time.¹⁵⁷²

950. Witnesses suggested that the approach of the FCA needs to become less retrospective and that it should deal with issues proactively. Douglas Flint told us:

The final thing that I will say [...] is about the need for more proximate interaction. We are dealing today with issues like PPI and interest rate swaps, where we are determining that it may not have been as it should have been for a very long time. We have to try to find a way, between the industry and the supervisor regulators, of being much quicker to identify that there is an issue and fixing it, rather than saying we have to compensate for something going back a significant number of years, because that makes it very difficult to think about what might happen in the future that you should have known about today.¹⁵⁷³

951. Sir Mervyn King agreed that specifically in the case of mis-selling:

if the conduct regulators are going to launch an accusation of mis-selling, they need to do it much closer to the date when the product has been "mis-sold". If it is possible to conceive of mis-selling a product, it ought to be possible to do it pretty close to the time when the product was sold [...] the banks have a point in being exposed to uncertainty for an indefinite period on an unknowable scale, when the regulators can simply deem something to be mis-selling.

952. The FSA has itself acknowledged that the way in which they handled past market failures was inadequate:

One of the key lessons we have learned from market failures, such as PPI, is that it can be much more effective to intervene early, to pre-empt and prevent widespread

1571Q 3862

1572Q 3863

1573Q 3852

harm from happening to consumers in the first place rather than clearing up after the event.¹⁵⁷⁴

Paul Geddes, Chief Executive of Direct Line Group, RBS, told us that a failure by regulators to be pro-active could contribute to customer detriment:

Early engagement at a very senior level to sort these things out immediately is absolutely imperative, because in the elapsed time, for reputation, it is expensive, it is bad for the customer and it is bad for trust.¹⁵⁷⁵

A bank indicated that it did not have confidence in the FCA delivering an approach that is not backwards-looking:

While we support the goals of the FCA to ensure adequate protection for consumers of financial services and their intention to be more forward-looking in their approach, we remain concerned that it will continue to be too backward-looking and disproportionate in respect of the costs of its interventions relative to the outcomes for customers that it seeks to achieve.¹⁵⁷⁶

953. The FCA has powerful new tools to intervene in products. These should not mask the fact that responsibility for the design and appropriate marketing of products lies with banks. The relationship between the FCA and banks should be such that concerns about products are resolved without recourse to the FCA's new tools. Their use by the FCA will carry significant risks. How the FCA's new product intervention tools are used will be a key indicator of its success in taking a judgement-led approach. The balance between intervening too early, distorting the market, and too late, potentially allowing customers to suffer, will be a delicate one, and how these tools are used will be an indicator of the FCA's success in taking a judgement-based approach. The Commission recommends that the Treasury Committee specifically consider the FCA's use of its product intervention tools in its inquiry into the supervisory approach.

954. Those who design and market products should be held responsible should those products be mis-sold to consumers. That personal responsibility must be clear from the way in which responsibilities have been assigned under the Senior Persons Regime. The nature of financial products where flaws may not appear for some time after the launch, and the information imbalances between banks and their customers, impose a particular duty on banks to test thoroughly what might go wrong with new products before their launch. It should also be their duty to ensure that products are not sold to the wrong people, and that staff incentives do not contribute to mis-selling. However, if these steps are properly taken, the mere discovery of risk in products cannot be held to constitute mis-selling, where such risks could not reasonably have been identified based on the information available either to the bank or to the regulator at the time that they were sold.

1574J Ev 255

1575JQ 386

1576Letter to the Commission from a UK bank [not published].

955. The Financial Services and Markets Act (FSMA) gives designated consumer bodies the right to make a “super-complaint” to the FCA where they consider that there are features of a market for financial services in the United Kingdom that may be significantly damaging the interests of consumers. HMT has responsibility for designating those consumer bodies. The FCA is required to respond to super-complaints within 90 days. The Commission heard how the regulators failed to deal with concerns about PPI adequately in the past. The Citizens’ Advice Bureau told us they raised concerns about PPI as early as 1995¹⁵⁷⁷ and yet it was over a decade later that any significant action was taken by the authorities to address the problem. The Commission heard that the way in which the FSA’s response to PPI was centred around individual complaints was inappropriate.¹⁵⁷⁸ Asked whether there was a need for a new form of collective redress, Natalie Ceeney told us that:

The FCA to be, and the FSA for the past couple of years, has that power. There was a power to do that even as early as 2008, which was essentially what we were calling for. The issue is that it has not been widely used. For example, the FSA has a power called section 404 of the Financial Services and Markets Act that allows it to create an industry-wide scheme to give compensation to a large group of customers.¹⁵⁷⁹

956. The FCA has produced draft guidance for designated bodies on how it will respond to super-complaints in future.¹⁵⁸⁰ This includes setting out how it proposes to deal with the complaint, explaining whether it has decided to take any action, and if so, what action it proposes to take, with reasons. Possible outcomes range from initiating a consumer redress scheme or deciding that no action should be taken. The FCA has stated that it will make the process straightforward for the organisations that may submit super-complaints.

957. The Commission notes the new arrangements for super-complaints and, in particular, that the FCA intends to make the process straight-forward for designated consumer bodies. The draft guidance appears to be a step in the right direction by making clear that the FCA will respond within 90 days, and setting out the action it proposes to take, with reasons. Given the potential for widespread consumer detriment arising from the subject of a super-complaint, we consider that the FCA should provide clear reasons when it does not consider that initiation of a collective consumer redress scheme is appropriate. It is important that proper, evidence-based, judgement is applied when handling super-complaints and that the 90-day time limit does not result in a process-driven approach.

Supervisory relationship with banks

958. We noted earlier in this chapter how engagement between the FSA and banks had been conducted at an inappropriately junior level with a focus on low level detail instead of material risk issues. Recognising this deficiency, both of the new regulators have stated that there will be more senior-level engagement in future. The PRA has stated that future

1577JQ 1

1578JQ 685

1579JQ 730

1580FSA, *Journey to the FCA*, October 2012, p 16, www.fsa.gov.uk

engagement with banks will be at an appropriately senior level, noting that “major judgements and decisions will involve the PRA’s most senior and experienced staff and directors”.¹⁵⁸¹ The FCA has said that it will “act more quickly and decisively and be more pre-emptive in identifying and addressing problems before they cause harm, with our senior staff involved in supervision issues at an earlier stage.”¹⁵⁸² The PRA will focus on material issues in its engagement with firms.¹⁵⁸³ The FCA has said that it will “focus on the biggest problems firms need to tackle.”¹⁵⁸⁴ Douglas Flint appeared to support this approach when he said that regulators should, in the senior-level discussions:

Focus on the big issues. If you are talking to the board, you should be talking about the issues that are at board level, which are the big structural issues: the risk appetite, culture, the quality of people, succession planning.¹⁵⁸⁵

959. Andy Haldane told us that discussions at an appropriately high level can be particularly useful in ensuring that the senior management of banks understand their business properly. He told us:

I think back to the approach to supervision and regulation when it was last done in the Bank of England. At the centre of that approach was a conversation at the highest level between the Governor of the day and the chief executive or chairman of the bank. That conversation was effectively a spot check on the adequacy of the senior management in understanding its business.¹⁵⁸⁶

960. An appropriately senior level of engagement which focuses on material risk issues will be important in successfully delivering a judgement-based approach to supervision as it will involve making judgements that banks sometimes disagree with, and in many cases, that banks do not like. Andrew Bailey told us that the regulators “accept that in a judgement-based approach to supervision, there will be disagreement. We don’t seek disagreement for the love of it, but it is part of what we do.”¹⁵⁸⁷

961. In order to ensure an appropriate level of engagement it will be essential for supervisory staff to escalate issues appropriately. Michael Foot explained the challenges faced by supervisors in this regard:

The great trouble that Andrew Bailey or somebody like him will face is this. He will have a relationship manager [...] for a major group, and that individual has a number of people working for them. They have access to credit experts, trading experts and operational risk people and to one or more ‘grey panthers’, who provide the external view. That group of people have to come up with a judgment that is basically sound about the risks and the opportunities, and then the senior people have to take that

¹⁵⁸¹PRA, *The Prudential Regulation Authority’s Approach to Banking Supervision*, April 2013, p 12

¹⁵⁸²FSA, *Journey to the FCA*, October 2012, p 25 www.fsa.gov.uk

¹⁵⁸³PRA, *The Prudential Regulation Authority’s Approach to Banking Supervision*, April 2013, p 30

¹⁵⁸⁴FSA, *Journey to the FCA*, October 2012, p 28, www.fsa.gov.uk

¹⁵⁸⁵Q 3852

¹⁵⁸⁶EQ 171

¹⁵⁸⁷ Bank of England, *The challenges in assessing capital requirements for banks speech*, Andrew Bailey, 6 November 2012, www.bankofengland.co.uk

and form the right judgments. [...] I suspect and hope that Andrew and his senior people will spend more time facing towards the industry, talking to them and being involved in this, but because of the sheer scale of the operations, there has to be a very clever process for bringing this together.¹⁵⁸⁸

962. In adopting their new approaches, the regulators will need to establish a relationship of trust with banks so that senior level discussions are open and frank. Michael Cohrs, Member of Financial Policy Committee, Bank of England, told us:

I do think it is important to have a relationship between the regulator and the senior management of a bank. It is a place where this country has not done a good job, because I had a feeling that if I went to my UK regulator with a problem or an issue—this is a personal opinion—it spiralled out of control. The next thing I knew, there were 20 guys from the regulator in, and it was on the front page of *The Times*.¹⁵⁸⁹

963. There are signs that the approach of the conduct regulator may not yet be conducive to a constructive relationship. A banker told us:

the tone of dialogue with staff at the FCA is often adversarial rather than that of a regulator with a shared agenda.¹⁵⁹⁰

964. Banks also need to do their part in creating a constructive supervisory relationship. The regulators' relationship with banks has been marred by banks resisting decisions they do not like or lobbying for decisions that are favourable to them. The FSA has noted that when it was investigating PPI:

We received considerable resistance from firms to the changes we suggested and requested; firms were more interested in the major revenue stream PPI offered than in improving standards and enforcement penalties alone were not enough to change behaviour. The resistance from firms has been a factor in us adopting a tougher penalties regime in 2010.¹⁵⁹¹

This behaviour appears to continue. Andrew Bailey told us:

What do you get for Christmas, as a regulator? You get a request to change somebody's model before the year end. What is all this about? What it is all about, essentially, is fitting your model to deliver an overall capital ratio that you think is the one you want to tell the world you have got. I do not fall for the fact that they all come in at the same time of year. There is a distinct seasonality to this.¹⁵⁹²

Such behaviour will need to change. The PRA *Approach to Banking Supervision* states that "firms should not [...] approach their relationship with the PRA as a negotiation."¹⁵⁹³

1588EQ 84

1589EQ 43

1590Letter to the Commission from a UK bank [not published].

1591J Ev 244

1592Q 4557

1593PRA, *The Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 6

965. A successful relationship between banks and regulators will depend on regular, frank discussions between the senior regulators and senior bank executives, including at chief executive level, that focus on important issues. Such a relationship should also be fostered by periodic attendance of the most senior regulators at the meetings of bank boards. The Commission recommends that the FCA and the PRA keep a summary record of all meetings and substantive conversations held with those at senior executive level in banks, the most senior representative of the FCA or PRA present in each case. We would expect those records to be made available on request retrospectively to Parliament, usually to the Treasury Committee.

Special measures

966. One of the main themes to emerge from our work is that many of seemingly discrete failings within the banking sector in recent years, often characterised distinctly as prudential failing or conduct failings, have common roots. In some of the evidence we took from banks, it was a notable feature that several apparently unrelated failings could be attributed to common weaknesses, many having their origin in a failure of standards at the most senior levels of the bank concerned. Numerous incidents across a wide range of business areas within a bank may be indicative of wide-scale failings in leadership, risk management and behaviour. As Tracey McDermott told us:

The other thing that I would say is a series of red flags—it was demonstrated by UBS, but also by some other firms—is a series of serious failures in different bits of the business. Some of them may not individually be massively significant, but what does that say about the culture if people in quite disparate parts of the organisation can basically get around the rules?¹⁵⁹⁴

967. Both regulators have emphasised the importance of the culture and overall approach by banks. The PRA has stated that it expects “firms to have a culture that supports their prudent management”.¹⁵⁹⁵ The FCA has indicated that it expects firms “to base their business model, their culture, and how they run their business, on a foundation of fair treatment of customers.”¹⁵⁹⁶ The standards and culture of a bank are a matter for the bank itself, and above all its Board. They cannot be imposed by regulators. As Michael Cohrs said:

We would be mistaken if we thought that the regulators can go into an organisation and impose a culture that they would like. The organisations themselves are going to have to do it, and we have to use incentive tools to create the right outcomes.¹⁵⁹⁷

968. The PRA and the FCA have each designed their own individual approach to assessing governance and culture in firms. The PRA assesses governance and management, and risk management and controls, through its risk framework.¹⁵⁹⁸ This draws on the FCA’s

1594Q 2317

1595PRA, *The Prudential Regulation Authority’s Approach to Banking Supervision*, April 2013, p 20

1596FSA, *Journey to the FCA*, October 2012, p 25, www.fsa.gov.uk

1597EQ 3

1598PRA, *The Prudential Regulation Authority’s Approach to Banking Supervision*, April 2013, p 12

findings on key conduct risks (such as money laundering) where they are relevant to the PRA's objective. An output from the PRA's risk assessment is to assign a bank to a Proactive Intervention Framework (PIF) stage which determines the ongoing intensity of supervision of a firm and regulatory actions. Further information on the PIF is provided in Box 17. The FCA reviews governance and culture as part of its Firm Systemic Framework, which is designed to assess a firm's conduct risk.¹⁵⁹⁹ The FCA does not have the equivalent of the PIF. Where either regulator identifies specific concerns through its routine risk assessment, or if issues of concern come to their attention from other sources, they may decide to conduct further action.

Box 17: Proactive Intervention Framework (PIF)

A bank's PIF stage is derived by the regulator's assessment of a bank through its risk framework. The stage indicates a firm's proximity to failure and determines the ongoing intensity of supervision. Examples are as follows:

- PIF Stage 1 (Low risk to viability): The bank is subject to normal supervisory risk assessment process and actions.
- PIF Stage 2 (Moderate risk to viability): The intensity of supervision increases. There may be additional reporting requirements and/or use of information gathering powers. The firm is required to address deficiencies over a set period.
- PIF Stage 3 (Risk to viability absent action by the bank): The regulator may require: a change to management and/or composition of the board; limits on capital distribution (including dividends and variable remuneration); restrictions on existing or planned business activities.
- PIF stages are not disclosed publicly.

969. In the US, the regulator of national banks (the Office of the Comptroller of the Currency (OCC)) may undertake informal enforcement action in response to identifying serious failings within the banks it supervises. Further information on the US approach is provided in Box 18.

Box 18: The US Approach

Prior to the OCC entering into formal enforcement action, the OCC has a number of informal actions available to it. These range from:

- a commitment letter: this is signed by the bank's board, reflecting specific written commitments to take corrective actions in response to problems or concerns identified by the OCC in its supervision of the bank;

- a Memorandum of Understanding (MoU): a bilateral document signed by the bank's board of directors on behalf of the bank and an authorised OCC representative. An MoU is drafted by the OCC and in form and content is similar to formal enforcement action. It legally has the same force and effect as a Commitment Letter.
- Safety and Soundness Plan: the OCC issues to the bank a notification of failure to meet safety and soundness standards and requires the submission of a Safety and Soundness Compliance Plan. The Plan must include a description of steps the bank will take to correct deficiencies and the time within which each step are to be taken. If approved by the OCC, the Plan functions as an informal enforcement action.¹⁶⁰⁰

970. **The advantages of twin peaks regulation have been set out elsewhere in this Report. However, it also carries the risk that, by focusing on their own individual objectives, the regulators fail to spot or tackle systemic weaknesses of leadership, risk management and control which underpin problems in different parts of the business. The Commission has concluded that the regulators should have available to them a tool, along the lines of the pro-active approach taken in the US, to identify and tackle serious failings in standards and culture within the banks they supervise. Use of the tool may be a precursor to formal enforcement action by the regulator if the bank fails to address the regulator's concerns satisfactorily.**

971. **As part of the continuing dialogue between the PRA and the FCA at the most senior levels within the two organisations, and through their risk assessment frameworks, we expect the two regulators to consider cases which might require the deployment of the tool we propose, which can be termed 'special measures'. Special measures will take the form of a formal commitment by the bank to address concerns identified by the regulator. Ahead of placing a bank in special measures, we consider that the regulators should commission an independent report to examine the extent to which their initial source of concern may be an indicator of wider conduct or standards failings. The regulators already have a power under section 166 of FSMA to commission a "skilled persons" report on a particular aspect of a bank's business. The benefits of this tool can be blunted when the "skilled persons" lack genuine independence, a problem highlighted by the report carried out by an audit firm into risk management in HBOS, which we considered in our Fourth Report.¹⁶⁰¹ It will be important for such reports to be truly independent. We consider it inappropriate therefore for a bank's auditors, or those who might compete to become the firm's auditors in the near future, to be appointed to carry out this task. There would be an expectation that reports would be prepared quickly.**

972. **Where the report reveals problems requiring rectification or there remains cause for regulatory concern, the Commission recommends that the regulators have a power to enter into a formal commitment letter with the bank concerned to secure rectification measures and to provide a basis for monitoring progress in addressing the concerns. The Commission recommends that a bank in special measures be subject to**

¹⁶⁰⁰OCC, *Policies and Procedures Manual*, September 2011, p 4, www.occ.gov

¹⁶⁰¹Fourth Report, paras 70-71

intensive and frequent monitoring by the regulators. An individual within the bank should be made responsible for ensuring that the remedial measures are implemented to the regulators' satisfaction. As part of this process, the regulators might wish to require the retention of an independent person to oversee the process from within the bank. The board's overall duties for rectification would not be in any way diluted by the identification of an individual within the bank responsible for implementing remedial measures or the retention of an independent person.

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

Supervisory resources

Staff

974. If regulators are to make their contribution to raising standards in banking, they need experienced and talented staff. The delivery of a judgement-based approach will, in particular, require senior and experienced staff who are able to deal confidently with the banks they regulate. Martin Wheatley acknowledged that changes are required to the FCA's staff in order to deliver the new judgement-based approach:

clearly we need either to upgrade or train our people. We need senior people who have a few more battle scars and are more prepared to use their judgement.¹⁶⁰²

975. Michael Foot told us that finding and retaining individuals to deliver the approach may be difficult:

the main difference between regulation and supervision is over the implicit requirement that supervision has to exercise judgement. I am very comfortable with what Andrew Bailey has said about how the PRA will try to operate this, but we all have to realise – I am sure that he realises – that the kind of skill sets you require to exercise that judgement are hard to find. We all know that regulators here are quite difficult to keep.¹⁶⁰³

The difficulty that the FSA had in retaining staff is noted in the FCA's *Journey to the FCA* document, which says that:

we face many challenges; for example, a significant number of people are leaving the FSA after being here four or five years, as we are often seen as an industry training ground.¹⁶⁰⁴

1602Q 214

1603EQ 55

1604FSA, *Journey to the FCA*, October 2012, p 57, www.fsa.gov.uk

The need for high quality staff may be particularly important in supporting real time intervention by the FCA to protect consumers from harmful products. Carol Sergeant noted that the use of the product intervention powers will require:

courageous people. [...] You have to be courageous to come in and say, “I am going to stop that product. I don't like it.”¹⁶⁰⁵

976. A particular challenge for the FCA in attracting talented staff may be the nature of its work, and the continued tendency towards low level analysis and extensive data gathering described above. As Douglas Flint explained:

If the role of the supervisor is much more to be high-level, understanding of the risks, and dealing at a senior level in organisations, that is a much more interesting career than the kind of much more minute data gathering, sticking it into a matrix and determining whether it comes out right. I think if the intellectual quality of the role is higher you will get better people.¹⁶⁰⁶

As Michael Foot also pointed out, the nature of the FCA's work may lack the appeal of more intellectually challenging roles:

intellectual challenge is one of the most exciting things you can offer people in the regulatory sphere. Unfortunately, being part of a working party in Basel or wherever tends to have more intellectual appeal to it than trying to sort out the plumbing in RBS's IT problems, for example. That is unfortunate. However, that intellectual appeal and approval within the narrow circle of regulators are the things on which you can build a career.¹⁶⁰⁷

977. The PRA will also need experienced supervisors in order to deliver its new approach. The PRA's *Approach to Banking Supervision* document notes that: “the PRA will have a larger proportion of more experienced and senior supervisors compared with the past.”¹⁶⁰⁸ The PRA may find it easier to attract the most talented staff than the FCA. This is because the prudential regulator will benefit from the broader range of expertise from within the Bank of England, which may enable it to attract the most talented staff in a way that was not open to the FSA, and is not open to the FCA.¹⁶⁰⁹ The PRA should benefit from the long established culture of the Bank of England. A banker told us:

Good judgement comes both from intellect and experience and experience is hard to fast track. That is part of the distinction between the Bank, the Treasury and the FSA. Those we deal with at the Bank and the Treasury typically have long service in both institutions and have considerable experience of the issues they are faced with.¹⁶¹⁰

Andy Haldane made a similar point:

1605EQ 111

1606Q 3855

1607EQ 61

1608PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 38

1609Letter to the Commission from a UK bank [not published].

1610*Ibid.*

I hope that bringing supervision into the Bank of England will broaden the base of human resources-human capital-that can be deployed in line supervising banks. On average that makes for somewhat more experienced supervision of firms than we have had over the last 10 to 15 years.¹⁶¹¹

The PRA's *Approach to Banking Supervision* document notes:

staff have the opportunity to work in other parts of the Bank of England as a way of broadening their knowledge and management experience, and similarly the PRA will be open to staff moving from other parts of the Bank.

It also notes that: "the Bank's recruitment, talent management and career development programmes have been extended across the PRA" and that the PRA offers "compelling careers centred around intellectual challenge and excellence, and a commitment to public service through its public policy objectives".¹⁶¹²

978. Andrew Bailey noted that since supervision moved to the FSA from the Bank of England, "there had been a substantial divergence in culture between the two organisations".¹⁶¹³ Change will not be achieved overnight. As Sir Mervyn King has pointed out:

focusing on the judgments that are needed does not require vast numbers of people, and my instinct would be true in the Bank of England too, that you do not need vast numbers of people, but you need the right people with the right focus and commitment, and that is going to be a challenge to us and it will take time to get there.¹⁶¹⁴

979. The PRA staff should benefit from the Bank of England's good record of providing rewarding careers that compensate for lower pay than the financial services industry can offer. Andrew Bailey told the Treasury Committee:

I can tell you [...] that this is hugely difficult work that we do, but it is hugely enjoyable, frankly, and we need people who have got that enjoyment of that combined with clearly a level of remuneration which says, "That is a reasonable combination for me". It is not easy to find, but we have had a good record, I think, in the Bank of England over the years of finding those people and keeping enough of them.¹⁶¹⁵

Michael Cohrs echoed this view in his evidence to us:

I would strongly encourage you to listen to Mervyn King's speech that he gives to graduates who come into the Bank or people who are thinking about what to do. He gives a very compelling speech about being in a career in bank regulation. He talks about a career, which is something, to be blunt, that you do not see financial

1611Q 643

1612PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, pp 38-39

1613Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 10, www.bankofengland.co.uk

1614Oral evidence taken before the Treasury Committee on 28 July 2010, HC(2010-12) 430, Q34 [Sir Mervyn King]

1615*Ibid.* Q44 [Andrew Bailey]

institutions talking about. They talk about money, about a year or about two years, but Mervyn gives a very compelling speech about a career.¹⁶¹⁶

Raising historical awareness

980. In Chapter 3, we set out how the history of banking failures repeats itself. It is therefore important that regulators, like bankers, try to learn the lessons of history. Christine Downton, founding partner of Pareto Partners, told us that “the problem in the recent crisis was once again the regulators lost the plot”.¹⁶¹⁷ She suggested that:

regulators should be trained more in the history of financial crises. We need to add to the training that regulators generally get. To have case studies of a range of financial crises would be an extremely useful addition to their training. [...] Financial crises don't often happen immediately one after the other: there tends to be a lag while those people who learnt lessons move out of the industry. I think we have seen that time and time again. [...] the only thing I can suggest is that people are required to have a greater grasp of the conditions in which financial crises occur.¹⁶¹⁸

Andy Haldane argued that catching financial crises relies on a lengthy sample of past experience, as a full crisis may last 20 to 30 years, with a systemic crisis only occurring once or twice a century. One of the secrets of making the new supervisory approach work will be the accumulated experience of supervisory staff.¹⁶¹⁹

981. We heard from Lord Turner and Martin Wheatley that ensuring supervisors learn the lessons of past financial crises has not formed part of the training programme for supervisory staff.¹⁶²⁰ Martin Wheatley told us that while the FSA had covered recent crises in its training, this only spanned the last five years:

We have built into our training certainly the lessons from the recent crisis-the past five years. It is an interesting point as to whether we should take a more expansive view and look at the repeated crises over a longer time period, but certainly the past five years have been very much built into our approach.¹⁶²¹

Lord Turner was in favour of increasing awareness amongst supervisors of historical events:

I will now encourage the PRA in particular to do that and to say, "Is there a history element of it?" You are quite right that there are a series of banking crises which have extraordinarily common features. Too much lending to commercial real estate-which goes up in value, which then encourages more lending and, for a period of time, makes people feel that the risks have disappeared-is one of the most common

1616EQ 39

1617E Ev 43

1618EQ 126

1619Bank of England, *The Dog and the Frisbee speech*, Andy Haldane, 31 August 2012, www.bankofengland.co.uk

1620Qq 4416-4417

1621Q 4417

features of everything from the Scandinavian crisis of the early 1990s to the Japanese, etc.¹⁶²²

982. The regulators have not customarily ensured that their staff acquire awareness of previous financial crises, even though it is evident that there is repetition in the underlying causes. This is a serious omission. The PRA should ensure that supervisors have a good understanding of the causes of past financial crises so that lessons can be learnt from them.

Cost of regulation

983. Regulation is often viewed as a free good. It is not; it has both direct and indirect costs. These are ultimately borne by consumers in higher prices or services forgone. Banks pointed out that there are very significant costs in terms of both compliance and management time, in addition to the annual fees paid to the regulator. Routine compliance and management costs were estimated to be as high as £100m for a large bank, with additional costs for regulatory projects increasing the amount by up to seven times.¹⁶²³ Costs have been rising as a result of the very significant increase in the number and scale of data requests (as outlined above), some of which require bespoke IT reporting solutions. The Bank of England has said that its “intention is that the PRA will operate, in the medium term, at lower cost than the equivalent part of the FSA”.¹⁶²⁴ Sir Mervyn King has stated:

I believe that we can operate prudential supervision at lower cost than hitherto by reducing the burden of routine data collection and focussing on the major risks to the system. [...] Targeted and focussed regulation, allowing senior supervisors to exercise their judgement, does not require ever-increasing resources.¹⁶²⁵

984. As discussed above, it remains to be seen whether savings from a reduced reporting requirement will be achievable given the increasing demands of European regulations. Furthermore, it is notable that the recently published combined Annual Funding Requirement (AFR) the PRA and FCA for 2013/14 is some 15 per cent higher than the AFR for the FSA in the previous year. The increase reflects in part a rise in the cost of front-line supervisory staff resulting from the move to a judgement-based, forward-looking and risk-focused approach to supervision, but also costs arising from investment in IT infrastructure and an increase in the cost of support services (such as HR functions) following the implementation of dual regulation, which are expected to reduce over time.¹⁶²⁶

985. The most recent increase in regulatory costs is intended to be largely transitional. A strategic aim of the FCA should be to become a smaller, more focused organisation.

1622Q 4416

1623Letter to the Commission from a UK bank [not published].

1624Bank of England, *Annual Report 2012*, p 36, www.bankofengland.co.uk

1625Speech by Sir Mervyn King at the Lord Mayor's dinner for bankers and merchants of the City of London, Mansion House, London, 15 June 2011

1626PRA, *Prudential Regulation Authority Regulated fees and levies: rates proposals 2013/14*, pp13-14

The Commission recommends that the FCA replicate the Bank of England's stated intention for the PRA to operate at a lower cost than its equivalent part of the FSA, excluding what is required to fund new responsibilities. The FCA should set appropriate timescales for implementation of this recommendation.

A role for senior bankers?

986. As well as a need to recruit and retain talented and committed staff, delivering a judgement-based approach will require the regulator to keep up to date with developments and innovations in the banking industry. The FSA had access to banking industry advice through the Financial Services Practitioner Panel (FSPP), with whom it consulted on new policy initiatives. While the FSPP provided a source of advice to the regulators, it also represented the interests of regulated firms, creating potential conflicts of interest. Both the FCA and the PRA have similar arrangements under the new statutory framework.¹⁶²⁷

987. The most effective way to ensure that regulators have access to independent and unconflicted advice is to bring the expertise in-house. One way to do so is to recruit individuals with banking expertise. Regulators face challenges, however, in attracting and retaining experienced staff with financial services industry expertise because they cannot pay the same salaries as the private financial services sector. In order to address the need for banking expertise, when supervision was conducted by the Bank of England before 1998, the accounting firms operated secondment programmes to the Bank's Banking Supervision Division.¹⁶²⁸

988. Senior individuals in banks are best placed to understand where the major risks lie and are most likely to crystallise as banks develop new products and engage in new activities. The skills of individuals who have developed the ability to understand and gauge these risks are not, however, currently harnessed by the regulator in any formal way. A banker told us:

There ought to be a way to bring people in from the industry to the FCA and the PRA, both at mid-career and possibly at the end of career by way of public service to an industry that has been good to individuals.¹⁶²⁹

989. Banks will continue to contribute to systemic risk and senior bankers owe a duty beyond the firm. Their enjoyment of high salaries is derived in part from structural features in the banking market, including the existence of an implicit taxpayer guarantee which means that bankers can receive exceptionally high rewards for taking a low level of personal risk. Douglas Flint and Stuart Gulliver both agreed that it would be reasonable for those who are the best placed to advise on how to handle risk discovery to give something back to society towards the end of their careers.¹⁶³⁰ Douglas Flint said that he would give

¹⁶²⁷Financial Services Act 2012, Arrangements for Counselling Practitioners

¹⁶²⁸Q 3856

¹⁶²⁹Letter to the Commission from a UK bank [not published].

¹⁶³⁰Q 3858

the question of whether he would be interested in joining a team of like-minded people to assist the PRA upon his retirement “favourable consideration”.¹⁶³¹

990. Senior bankers owe an enduring duty to mitigate systemic risk. The best gamekeepers are usually former poachers. The most senior individuals in banks, such as Chairmen and Chief Executives, should be the best placed to understand where risks lie within banks as new products are developed and banks engage in new activities. When they no longer work for the bank, such individuals are well-placed to give their views to supervisors on regulatory policy developments and supervisory judgements, such as the risks presented by new products and within bank business models.

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

Regulatory Framework

Basel III and Europe

992. The regulatory framework is increasingly governed by international rules and regulations. The foundations for the regulations are non-statutory Basel Accords, which are underpinned by national legislation and rule-making.¹⁶³² Basel II is being replaced by Basel III, which is being implemented in the UK through the CRD IV Directive and Capital Requirements Regulations. Basel III imposes higher capital requirements and introduces a new minimum 3 per cent leverage ratio and new liquidity requirements. Basel III continues to bear, however, many of the flaws of Basel II and adds further layers of complexity. Basel I was 30 pages long, Basel II came in at 347 pages, and the documents that make up Basel III add up to 616 pages. For a large complex bank, there has been a rise in the number of calculations required from single figures a generation ago to several million today. The number of estimated parameters required to calculate risk in a large bank’s trading and banking books could now run to several million.¹⁶³³ Michael Foot told us:

I have to say that I think Basel III is somewhat better than Basel II, but I don’t for a minute think that the regulators have learnt the lesson.¹⁶³⁴

Sir Mervyn King pointed out that:

the more detailed the Basel regime has become, inevitably the more inflexible it has become. It has become inflexible in areas where actually you need flexibility, such as risk weights on mortgages.¹⁶³⁵

1631Q 3857

1632Bank of England, *The Dog and the Frisbee speech*, Andy Haldane, 31 August 2012, www.bankofengland.co.uk

1633*Ibid.*

1634EQ 48

Box 19: Liquidity and capital requirements under Basel III

Basel III incorporates both minimum capital requirements, and, for the first time in internationally-agreed regulation, minimum liquidity requirements.

The minimum capital requirements build on Basel II in using the concept of risk-weighted assets and the use of internal models is still permitted in some cases. However, the risk weights applied to trading book assets have generally been increased, alongside an increase in the minimum requirements for the ratio of capital to risk-weighted assets.

A leverage ratio requirement has been introduced which requires a minimum required ratio of capital to unweighted assets. This is a regulatory backstop which supplements the minimum required ratio of capital to risk-weighted assets.

The minimum liquidity requirements have two main elements. First, to improve the short-term resilience of the liquidity risk profile of financial institutions, there is a Liquidity Coverage Requirement. Second, to ensure that an institution has an acceptable amount of stable funding to support the institutions assets and activities over the medium term, there is a Net Stable Funding Requirement.

While Basel III imposes higher capital requirements on banks than did Basel II, important anomalies remain. For example, sovereign exposures carry a zero risk weight in cases where the sovereign is rated AAA to AA- or, at the national supervisor's discretion, in the case of domestic currency sovereign debt holdings funded in domestic currencies. Mortgage assets, which form a very large proportion of some banks' assets, are still eligible for internal rating; and there is no certainty that different banks will apply consistent weights to them.

993. In written evidence, Stilpon Nestor noted that bank boards following detailed Basel II capital adequacy measures had missed obvious risks, such as increasing gross leverage and decreasing liquidity, but that new risks were now emerging under Basel III:

While Basel III now “catches” these particular elephants, history teaches us that there are others roaming free and undetected—and that sooner or later they will strike. Sovereign risk exposures that carry zero risk weight in the Basel III calculation of the denominator of capital adequacy are a good reminder of the dangers that lie ahead. If all banks are made to think inside the regulatory box, it is unlikely that they will catch any of these new elephants.¹⁶³⁶

In addressing the problems with Basel III, Andy Haldane told us that an important step was to convince regulators at an international level to change approach. He told us:

I have been encouraged to see, over the course of the last few months—perhaps the last six months—that there is an increasing awareness among international regulators that we may have, indeed, taken a false turn. There are moves now afoot within the

Basel committee to seek ways of simplifying and streamlining, and to move to a proper, regulatory-rather than self-regulatory-edifice.¹⁶³⁷

994. Basel III is a harmonisation of minimum standards which means that national regulators may impose additional requirements on the banks they regulate. Through the implementation of CRD IV and the Capital Requirement Regulations, the EU has been moving in the direction of maximum harmonisation which reduces the flexibility of national regulators. Further information on CRD IV is provided in Box 20. Michael Foot said that he was:

strongly against any move within the EU to force complete harmonisation and not allow a country to have higher standards if it wishes. In terms of whether we should just be pushing ahead on our own, the UK is very well equipped.¹⁶³⁸

Box 20: CRD IV and the Capital Requirements Regulations

- Basel III will be implemented in the EU through the Fourth Capital Requirements Directive (CRD IV) and Capital Requirements Regulations (CRR). In the EU, a directive lays down certain results that must be achieved in Member States.¹⁶³⁹ National authorities have to adapt their laws to meet these goals, but are free to decide how to do so. Directives therefore allow greater levels of national discretion. Regulations become law in Member States as soon as they are passed by the EU authorities and become legal binding on a par with national law.¹⁶⁴⁰ This removes the major sources of national divergence (from different interpretations being applied and “gold-plating”).¹⁶⁴¹
- Traditionally, EU law has been implemented through directives, following principles of “minimum harmonisation”. Such an approach of setting minimum standards allows flexibility for national regulators to reflect national features and risks, and to address situations where the EU transposition of Basel is thought to be inadequate. This approach has not unduly constrained the use of judgement.
- The EU has been moving in the direction of greater “maximum harmonisation” (for instance through the use of CRR in relation to bank capital adequacy). This will constrain the ability of the PRA to use its flexibility to go above set standards. Where sensible judgement needs to be exercised, the means by which it is achieved in a world of maximum harmonisation becomes more indirect and thus less transparent. There is a cost to such approaches in terms of the clarity of policies and supervisory actions.

1637EQ 155

1638EQ 53

1639“Directives– definitions”, *European Commission*, 11 June 2006, www.europa.eu

1640“What are EU regulations?”, *European Commission*, 25 June 2006, www.europa.eu

1641“CRD IV/CRR – Frequently Asked Questions”, *European Press Release MEMO/13/272*, 21 March 2013, www.europa.eu

- EU processes have also moved in the direction of using more detailed rule-making, both at the level of legislation (Directives and Regulations) and the Technical Standards that are developed and implemented by the European Supervisory Agencies (EBA, EIOPA, ESMA). Rules which apply to 27 countries tend to require more detail to deal with the inevitable exceptions to reflect national circumstances. This also brings a much larger overhead of monitoring and compliance in regulatory bodies and firms.
- The European Banking Authority has proposed the creation of a single Handbook of supervision. This may be a precursor to attempts to harmonise not just the rules of supervision but also the process of supervising and thus the application of judgement. The ECB is also expected to develop its own Handbook. The extent of overlap risks a substantial lack of clarity in this area and will bear close monitoring.

995. A particular concern is that maximum harmonisation may restrict the national regulator from exercising discretion and from successfully delivering a judgement-based approach. Andrew Bailey pointed out:

a number of developments either have, or are likely to, pose a risk in future to the exercise of appropriate judgement. The introduction of “maximum harmonisation” (for instance in the Regulation (CRR) part of the overall CRD4 package for bank capital adequacy) will constrain the ability of the PRA to use the flexibility to go above minimum standards.¹⁶⁴²

Furthermore, the European Banking Authority’s proposal to create a single ‘Handbook’ of supervision is a step in the direction of harmonising not just the rules of supervision, but also the process of supervising banks and thus the application of judgement.¹⁶⁴³

996. The UK regulator has been considering what measures it can take at a national level to address the deficiencies in Basel III and CRD IV/CRR. Andy Haldane told the Commission that one of the things the UK regulator could do is to require greater transparency regarding the inputs into internal models. Furthermore, he further suggested that where the UK regulator has misgivings about the robustness of models, it could require something simpler and more robust in their place.¹⁶⁴⁴ The Commission was told that internal models are particularly inappropriate for portfolios of assets which contain large idiosyncratic loans, such as commercial property portfolios. Andrew Bailey described commercial property models as “ropey”.¹⁶⁴⁵ The PRA has therefore introduced a more robust approach for commercial property portfolios, which could be extended to other asset classes. A further measure that the PRA has explored is the imposition of floors in models below which capital would not be allowed to fall irrespective of a model’s output.¹⁶⁴⁶

¹⁶⁴²Ev 1607

¹⁶⁴³*Ibid.*

¹⁶⁴⁴EQ 155

¹⁶⁴⁵Q 4557

¹⁶⁴⁶EQ 155

997. The international regulatory approach implemented through Basel II was deeply flawed. Basel III and the associated EU legislation do not address these flaws adequately. Indeed, they add further layers of complexity, and continue to allow large banks to use unreliable internal models to calculate their capital requirements. Increased complexity in regulation creates an illusion of control by regulators, but in practice it leads to less effective regulation. The Bank of England should report to Parliament on the extent to which, in its view, the shortcomings of Basel II have been addressed by Basel III, and whether they consider that any improvement to the process through which the Basel accords are agreed could lead to better outcomes.

998. Given the UK banking sector's considerable size, it is important that, if the pace of international change in banking regulations is not sufficiently rapid, the UK should do more at a national level to address the deficiencies. The Commission notes that steps are already being taken by the PRA in that direction. The PRA should provide an explanation if it considers that there are legal constraints at a European level which prevent them from pursuing the desired regulatory approach.

Capital

999. Regulators are concerned with ensuring that banks maintain appropriate capital resources, both in terms of quantity and quality. There is an expectation that a significant proportion of a bank's capital will be of the highest quality—ordinary shares (equity) and reserves (retained earnings). All capital is expected to be capable of absorbing losses. Banks are expected to refrain from innovation in new capital instruments intended to contribute to regulatory requirements if they are ineffective at absorbing losses. Lower quality capital may, however, play a role when a bank has failed.¹⁶⁴⁷

1000. The Commission noted in its First Report the importance attached to resolution in the new regulatory regime and that a bail-in regime is being designed as a resolution tool for large systemically-important banks. Under such a regime, creditors holding bail-in bonds would share in the losses of a bank in an insolvency scenario. We noted, however, that there are doubts about the workability of such a regime and whether it will be agreed at an international level. In particular, the Commission raised a concern as to whether it was realistic to expect that in a crisis the authorities would be willing to exercise their powers to impose losses on creditors.¹⁶⁴⁸ Since our First Report, a form of bail-in has been used in Cyprus to deal with financial crises. Large depositors in banks were required to accept a reduction in the value of their deposits and so bear a share in the losses of the banks in which they had invested. These measures were met with a strong negative reaction (although this did not result in restitution). Cyprus is one of the few cases where bail-in has been attempted. Its circumstances were unusual, however, and it remains to be seen how bail-in could be applied in the case of a large bank in the UK. As we note in Chapter 4, there remain questions about the extent to which we can be confident about relying on bail-in tools to tackle the too-big-to-fail problem.

¹⁶⁴⁷PRA, *Prudential Regulation Authority's Approach to Banking Supervision*, April 2013, p 24

¹⁶⁴⁸First Report, para 237

1001. The Commission also reported that there may not be sufficient demand for bail-in debt, particularly amongst traditional large holders of bank debt, such as pension funds. However, when this point was raised with Sir Mervyn King, he suggested that bail-in bonds might be investable for certain types of pension fund, notably defined contribution pension funds which are able to invest in higher risk assets. He acknowledged that such investments might not be suitable for defined benefits funds which need to match their assets and liabilities.¹⁶⁴⁹

1002. In Chapter 3, it is noted how excessive reliance came to be placed on credit rating agency ratings. Such ratings have also been hardwired into the regulatory system. The most pervasive regulatory use of such ratings has been in determining capital requirements for banks.¹⁶⁵⁰ Regulators have been trying to reduce reliance on rating agency ratings, but progress has been slow. In response to demands in 2012 by G20 Ministers and Governors for further progress in ending mechanistic reliance on such ratings, the Financial Stability Board reported back in November 2012 with a “roadmap” with milestones for action.¹⁶⁵¹ **Progress by regulators internationally in weaning themselves off dependence on credit rating agency ratings for the purpose of assessing capital adequacy is essential. The Commission recommends that the regulators prepare a report for Parliament on progress made and further plans for action by June 2014.**

Leverage

1003. In Chapter 3, we highlighted that the absence of a regulatory leverage ratio requirement meant that regulators failed to prevent banks pursuing aggressive growth strategies. Instead, regulators relied on a flawed approach that involved using risk weighted assets (RWAs) and internal models to calculate regulatory capital requirements. In oral evidence, Andy Haldane described the inputs to models as “a complete black box”.¹⁶⁵² The lack of transparency resulted in huge inconsistencies in risk asset weightings, as confirmed by the results of a survey by the Basel Committee on Banking Supervision, which handed the same hypothetical trading portfolio to 15 large banks in nine countries and asked them to calculate the total capital required to support it. The results ranged from €13m to €35m, and in several cases the variation within individual asset classes—such as credit risk or interest rate portfolios—was more than eight times.¹⁶⁵³

1004. Since its First Report, the Commission has taken further evidence that the problems associated with RWAs will not be solved, which reinforces the need for a robust leverage ratio. Sir Mervyn King was sceptical of risk weights, which are set by international agreement and difficult to change, noting:

1649Q 4589

1650Bank of England, *Financial Stability Paper No.9: Whither the credit ratings industry?*, March 2011, p 6, www.bankofengland.co.uk

1651Financial Stability Board, *Roadmap and workshop for reducing reliance on CRA ratings: FSB report to G20 Finance Ministers and Central Bank Governors*, 5 November 2012, www.financialstabilityboard.org

1652EQ 155

1653“Study fuels fears on bank safety”, *The Financial Times*, 31 January 2013, www.ft.com

It is somewhat absurd, for example, that a zero risk weight is applied to sovereign debt when there are certain types of sovereign debt that no one in their right mind would think was appropriate to have a zero risk weight. The same applied to mortgages. Indeed, to my mind the most stunning example of that was Northern Rock which, in the summer of 2007, not only said that it wanted to return capital to its shareholders because it had too much, but it was the most highly capitalised bank in the United Kingdom according to the official risk weights. Yet, within literally weeks, it ran out of money. That tells you quite a lot about how inadequate the normal risk weighted measures of capital can be.¹⁶⁵⁴

1005. As noted above, the absence of a leverage ratio is being addressed through Basel III and was also considered by the Independent Commission on Banking (ICB). As the Commission noted in its First Report, the Government chose to reject the ICB's recommendation that the leverage ratio should be increased from the 3 per cent imposed by Basel III to 4.06 per cent, which would be consistent with the proposed increase in Tier 1 capital requirements for large ring-fenced banks from 8.5 per cent to 11.5 per cent of RWAs.¹⁶⁵⁵

1006. Banks and building societies who hold a large proportion of their assets in the form of loans that attract a low risk weighting under the RWAs approach (notably mortgages) have raised particular concerns. This is because the imposition of a leverage ratio may require them to hold more capital against the same portfolio of assets. The Chancellor lent his support to these arguments, telling us:

There are some banks that, frankly, we would regard as engaging in less risky activity than other banks but that would be more affected by a leverage ratio, which seems a bit perverse.¹⁶⁵⁶

He also described “compelling” representations made to HMT Treasury by banks in respect of the leverage ratio.¹⁶⁵⁷

1007. Building societies have argued that, as they face constraints in raising capital because of their mutual status, they may have to restrict lending.¹⁶⁵⁸ It should however be noted that building societies were not immune from the impact of the financial crisis, with a number either failing (Dunfermline)¹⁶⁵⁹ or being acquired by other building societies (such as Chelsea¹⁶⁶⁰ and Norwich & Peterborough)¹⁶⁶¹. Sir Mervyn King agreed that issues in the building society sector were not a sufficient argument against a higher leverage ratio:

1654Q 4512

1655 First Report, para 294

1656Q 4320

1657Q 4323

1658Ev 895

1659HM Treasury, *Dunfermline Building Society* Financial Sanctions, www.financialsanctions.hm-treasury.gov.uk

1660 “Financial Services Authority confirms Chelsea Building Society merger with the Yorkshire Building Society”, *FSA Press Notice*, FSA/PN1050/2010, 19 March 2010, www.fsa.gov.uk

1661 “Financial Services Authority confirms Norwich and Peterborough Building Society merger with the Yorkshire Building Society”, *FSA Press Notice*, FSA/PN1081/2011, 23 September 2011, www.fsa.gov.uk

Lord Turnbull: [...] Are we allowing the Nationwide tail to wag the dog—that the leverage ratio that would be suitable for the industry generally is not being put in place, because we haven't found a particular solution for one segment of this market?

Sir Mervyn King: It is the tail wagging the dog. There is a separate issue about mutuals and building societies in general, which has never been resolved. It is how you ensure that there is an adequate loss-absorbing capacity before the depositors are called upon to bear losses, given that in a mutual organisation they are, in effect, the shareholders. This problem has not been properly resolved. We raised it way back in 2007-08, and it has been a problem that has been overhanging us since, without any resolution. There is a need to deal with that problem, but it is quite separate from the question of the appropriate levels of leverage for banks.¹⁶⁶²

1008. We received highly persuasive evidence that the 3 per cent leverage ratio requirement imposed by Basel III is too low. The ICB's 4.06 per cent ratio may have suggested spurious precision, but the principle that the leverage ratio needs to be raised as well as RWAs is sound. This view is supported by Sir Mervyn King, who told us:

in the crisis, it was not risk-weighted capital ratios, but leverage ratios that proved a better predictor of which banks would get into difficulty. It is why I personally would attach more weight to a leverage ratio as a means of stopping some major problem. Supervisors would normally say that they want to use leverage ratios as a backstop. I understand that. It is a sensible thing to do, but I would rather have a tighter backstop than 33:1.¹⁶⁶³

Sir Mervyn King said that he would be “much happier” with leverage ratios of 10 to 20.¹⁶⁶⁴ Andy Haldane pointed out that during the crisis 4 per cent would not have been sufficient to prevent some of the banks failing and that longer term there is a programme of work to be done to explore whether even 4 per cent is sufficiently prudent:

Personally I would be setting that leverage ratio at a somewhat higher level than that currently prescribed by Basel III. As you know, it is set at 3 per cent, or 33 times leverage. During the crisis, we found that those levels of leverage were often a recipe for failure and, in the longer term, there is a strong case for thinking about a leverage ratio north of that 3 per cent, and one that is not reliant on risk weight.¹⁶⁶⁵

1009. The leverage ratio imposed by Basel III is considered to be a regulatory backstop, with RWAs still perceived as the key regulatory tool for mitigating risk on banks' balance sheets. There is a question, however, of whether the leverage ratio should be a frontstop in some cases given that for the most complex banks this simpler measure appears to have had greater pre-crisis predictive power than measures based on complex risk weightings.¹⁶⁶⁶ Andy Haldane has pointed out that the introduction of a leverage ratio under Basel III is good news from a robustness perspective but “less good is the fact that

1662Q 4510

1663Q 4513

1664Q 4511

1665EQ 155

1666Bank of England, *The Dog and the Frisbee speech*, Andy Haldane, 31 August 2012, www.bankofengland.co.uk

there will be a clear hierarchy of solvency rules with the frontstop provided by a risk weighted capital ratio and with the leverage ratio serving as backstop. In the hierarchy, leverage will be second in line.”¹⁶⁶⁷ There is a case for the hierarchy to be reversed, “with the leverage ratio playing the frontstop role given its simplicity and superior predictive performance”.¹⁶⁶⁸ Michael Cohrs was also a strong supporter of the leverage ratio, telling us: “leverage ratio-total assets divided by equity, that is how I would regulate the banking system. It is the only indicator. [...] So that is how I would come at financial regulation; I would rely heavily on simple leverage ratios”.¹⁶⁶⁹ The Chancellor was not supportive of the leverage ratio being a front stop:

having thought about it and having looked at the impact on a number of building societies and banks, our feeling was that it would become the front-stop rather than the back-stop, and, as I said, I am a big supporter of the leverage ratio but it should act as a back-stop.¹⁶⁷⁰

1010. The Chancellor was also not supportive of our recommendation to give the FPC the role of determining the leverage sooner than initially proposed by the Government. He told us:

We have a reasonable compromise, which is that we are trying to get—indeed, we are succeeding in getting—a 3 per cent leverage ratio implemented at a European level. Our commitment to the Financial Policy Committee has been to give them a leverage tool by 2018—subject to a review in 2017, so there is a caveat—but, in other words, not to proceed so far ahead of the European pack that we are not even getting the European rules agreed before we are implementing our own rules.¹⁶⁷¹

1011. The Commission is disappointed at the Government’s negative response to our recommendation in our First Report that the FPC be given responsibility for setting the leverage ratio. As we noted in our Second Report, Dr Carney has said that it is “essential to have a leverage ratio as a backstop to a risk-based capital regime.”¹⁶⁷² **We have two major concerns. First, we consider that the 3 per cent minimum leverage ratio is too low. Second, we see no good reason for the Government’s proposal to delay a review of the FPC’s proposed power to determine leverage ratios until 2017. We note that the Chancellor’s explanation regarding the Government’s rejection of a higher leverage ratio relied on allegedly ‘compelling’ representations to the Treasury that a higher ratio would cause unintended damage; the Commission is not persuaded. If problems are created for banks with particular characteristics, they should be addressed by specific derogations not by reducing the leverage ratio for all banks.**

¹⁶⁶⁷*Ibid.*

¹⁶⁶⁸*Ibid.*

¹⁶⁶⁹EQ 8

¹⁶⁷⁰Q 4320

¹⁶⁷¹ *Ibid.*

¹⁶⁷² Parliamentary Commission on Banking Standards, Second Report of Session 2012–13, *Banking reform: towards the right structure*, HL Paper 126, HC 1012, para 74

1012. The Commission has heard further evidence since its First Report which supports its view that the leverage ratio should be set substantially higher than the 3 per cent minimum proposed under Basel III. We noted in our First Report that the leverage ratio is a complex and technical decision best made by the regulator and it should certainly not be made by politicians. We recommended that the FPC should be given the duty of setting the leverage ratio from Spring 2013. We are disappointed that the Government has not accepted this recommendation.

1013. If the regulators' and supervisors' independence is to be meaningful, the setting of the leverage ratio must form part of their discretionary armoury. We urge the Government to reconsider its position on responsibility for the setting of the leverage ratio. Were the Government to maintain its current position, the Commission further recommends that the newly-established FPC publish its own assessment of the appropriate leverage ratio. This will bring transparency to any gap between the preference of skilled policy-makers and the views of politicians. The latter are at risk, particularly in the current environment where several banks are still wholly or partly State-owned, of succumbing to bank lobbying. Furthermore, the FPC should consider explicitly the question of whether the leverage ratio should be a regulatory front-stop rather than a back-stop given the recognised deficiencies in the risk-weighted assets approach to assessing capital adequacy. This work should be completed and the results made public by the end of the year.

Aligning tax rules with regulatory objectives

Inappropriate tax incentives

1014. As we explained in the previous section, in ensuring the safety and soundness of banks, regulators are concerned with limiting excessive leverage in banks' balance sheets and in ensuring that banks hold high quality, loss absorbent, capital. Existing tax rules are, however, misaligned with these objectives. Banks fund their assets with a mixture of debt (by borrowing from creditors through issuing debt instruments and accepting deposits) and by issuing shares to shareholders (equity). Under the current UK corporate tax system, banks can deduct from their taxable profits interest payments to creditors but not dividends paid to shareholders.¹⁶⁷³ This creates a tax incentive (or 'tax bias') for banks to issue debt rather than equity and so is misaligned with regulatory objectives. Andy Haldane has argued that current complexity in regulation arises partly to compensate for this situation:

One of the reasons why we have not just capital regulation but very complex capital regulation is that we are trying to induce banks to do something that the tax system at present provides a disincentive to do, which is to raise extra equity. So my hope would be that if the differential treatment were to be removed, banks themselves

¹⁶⁷³The Government confirmed that interest on Additional Tier 1 and Tier 2 hybrid instruments would be deductible in the Budget in March 2013. See paragraphs 2.116 and 2.117 of HM Treasury, *Budget 2013*, HC 1033, March 2013, paras 2.116 and 2.117, www.hm-treasury.gov.uk.

would have fewer disincentives and perhaps even some incentives to hold sufficient equity and that would lessen the burden on this complex regulation.¹⁶⁷⁴

1015. The relationship between tax and leverage is, however, complex and the extent to which tax rules encourage leverage in banks is debatable. While modelling by economists and academics finds that the tax bias does influence levels of debt in banks, tax practitioners and banks argue that regulatory requirements relating to capital, liquidity and leverage are more compelling reasons behind banks' choice of financing.¹⁶⁷⁵ The BBA has pointed out that debt versus equity options are also limited by capital markets; reasons why investors might prefer debt over equity include risk appetites and reliability of income streams.¹⁶⁷⁶

1016. Not only does the tax system incentivise banks to increase leverage, it also disincentivises banks from holding capital in its highest quality form (equity) and encourages banks to hold capital in hybrid instruments. Hybrid instruments are neither pure equity nor pure debt, but typically lie somewhere between the two, with characteristics of each. Such instruments are favoured by banks because they represent a lower cost of capital after tax: they are permitted by Basel regulations to qualify for Tier 1 and Tier 2 capital status, while retaining favourable debt characteristics such as interest deductibility. It is notable that the UK hybrids market grew to around \$100 billion between 2000 and 2007, representing around 25 per cent of UK banks' tier 1 capital.¹⁶⁷⁷ A former senior adviser to the OECD pointed out:

There is anecdotal evidence of the tax bias to debt encouraging higher levels of gearing by companies, and banks have tended not only to gear up to the levels of debt allowed under regulatory capital rules but also to issue hybrid, equity-like, forms of debt, rather than ordinary share capital, where that satisfied both the regulators and the conditions for a tax deduction.¹⁶⁷⁸

While hybrid instruments can have a place in a bank's overall capital, they are less loss-absorbent than pure equity. Commentators including the IMF and OECD are cautious about encouraging their use, noting that "[...] innovation in financial instruments has increasingly blurred the distinction between debt and equity and might have opened new options for tax avoidance" and concluding that "there may be a case for tax systems not to encourage Tier 1 capital to be issued in the form of debt-like instruments (which in regulatory terms are functioning as equity.)"¹⁶⁷⁹

1674HQ 114

1675See IMF Staff Discussion Note, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 3 May, 2011, www.imf.org; IMF Working Paper, *Debt, Taxes and Banks*, February 2012, www.imf.org; IMF Working Paper, *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations*, April 2011, www.imf.org; IMF Working Paper, *Taxation and Leverage in International Banking*, November 2012, www.imf.org.

1676See for example H Ev 312.

1677Bank of England, *Control rights (and wrongs)* speech, Andy Haldane, 24 October 2011, www.bankofengland.co.uk

1678Geoff Lloyd, *Moving beyond the crisis – strengthening understanding of how tax policies affect the soundness of financial markets*, July 2009, www.itdweb.org

1679IMF Staff Discussion Note, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 3 May, 2011, www.imf.org; Geoff Lloyd, *Moving beyond the crisis – strengthening understanding of how tax policies affect the soundness of financial markets*, July 2009, www.itdweb.org

1017. Banks' use of hybrids in this way illustrates the way in which the tax system can pull against, rather than alongside, regulatory objectives. Neutralising the tax differences between debt and equity would not only create incentives for banks to hold capital with more loss-absorbent properties, it would reduce arbitrage opportunities. Professor Devereux, Director of the Oxford University Centre for Business Taxation, told us that:

We cannot see any good reason why debt and equity should be treated differently by the tax system as a matter of principle. Indeed, the fact that they are treated differently by the tax system creates a number of distortions—both to the behaviour of banks and for other companies—and a number of problems with the administration of the system in trying to define what debt and equity are.¹⁶⁸⁰

Similarly, Ernst & Young thought it important for the tax system to support regulatory objectives, and observed that the current tax rules do not do so on a consistent basis:

It would be helpful if the tax system were aligned to incentivise similar behaviour to regulation, so that complying with regulations does not penalize banks from a tax perspective.¹⁶⁸¹

The Government also noted that “taxes and regulation face complex complementarities and potential trade-offs, which are still poorly understood.”¹⁶⁸² Bank behaviour is more constrained by regulation and corporate governance measures than by tax.¹⁶⁸³ ACCA has argued: “the tax system sets boundaries for what can legally be done, but it is not in itself a suitable tool for promoting that which ought to be done.”¹⁶⁸⁴

1018. The extent to which tax rules encourage leverage in banks is disputed but the fact that they do provide an incentive is not. Tax rules are misaligned with regulatory objectives in that they reward banks for financing their activities through issuing debt rather than equity and so increase leverage, and create a disincentive for banks to hold capital in the most loss absorbent form. Removing the tax bias could address this misalignment and contribute generally to financial stability. Options are explored below.

Options to achieve tax neutrality

1019. Removing the tax bias would provide a level playing field between debt and equity, otherwise known as tax neutrality. Introducing tax neutrality for the banking sector would provide banks with more of an incentive to hold more capital in relation to debt than is currently the case and has been advocated by Sir Mervyn King amongst others, who said that he was “in favour of a neutral tax treatment of different types of investment income and income from capital.”¹⁶⁸⁵

1680HQ 1

1681H Ev 184

1682H Ev 172

1683HQ 178

1684H Ev 128

1685Q 4581

1020. Amongst the range of reforms possible, there are two main options which would achieve tax neutrality. One option would be to remove the deductibility of interest payments, thus placing debt on a level footing with equity. This is called the ‘Comprehensive Business Income Tax’ (CBIT). Under CBIT, banks are disallowed a deduction for interest expenses, but are not taxed on interest income received on outstanding loans to other firms.¹⁶⁸⁶ There are no current, international examples of CBIT in practice as there are a number of practical obstacles including the difficulty of unilaterally introducing a new tax system which would result in higher tax bills for companies with debt, competition disadvantages in attracting investment by multinational enterprises and the potential for double taxation. Nonetheless, the United States Congress is considering whether CBIT could be used to offset a reduction in the headline rate of corporation tax.¹⁶⁸⁷

1021. The other option, which most observers believe to be more practical, is called the ‘Allowance for Corporate Equity’ (ACE) and has been adopted by a small number of countries who did not limit this reform to the banking sector.¹⁶⁸⁸ Under the ACE, companies would deduct from their taxable profits their interest payments plus an amount equivalent to what they would have to pay their shareholders in interest if all the company's equity were debt (the notional return on equity).¹⁶⁸⁹ The Mirrlees Review called for an introduction of an ACE system as part of wide-ranging reforms to the entire tax system.¹⁶⁹⁰ This would incentivise borrowers to issue new equity in exchange for debt, contributing both to financial stability and to the outlook for economic recovery.¹⁶⁹¹ However, introduction of an ACE could justifiably be limited to banks on the basis that over-leverage in banks is particularly harmful and can have a more dramatic effect than in the rest of the economy by leading to financial instability. Providing an incentive for banks to hold more equity in relation to debt by means of an ACE is therefore a legitimate tool to influence bank behaviour in this regard.

1022. The Treasury and HMRC told us that introducing any reform would involve practical problems: “measures designed to directly address the debt-equity bias in the tax system would be disruptive, and would have unpredictable—but potentially significant—behavioural and location effects.”¹⁶⁹² They also argued that given that corporation tax rates in the UK are following a downward trajectory: “these reductions will significantly reduce the distortion, and therefore by implication reduce any benefit that can be achieved from

1686IMF Staff Discussion Note, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 3 May, 2011, www.imf.org

1687Joint Hearing of US House of Representatives Committee on Ways and Means & US Senate Committee on Finance, *President's Framework for Business Tax Reform*, 13 July 2011, www.waysandmeans.house.gov

1688In Europe, Croatia, Italy, Austria, Latvia and Belgium have all implemented variants of an ACE. At present, Belgium, Brazil and Latvia continue to use a form of ACE. A recent tax committee of the Dutch government has also proposed an ACE - The Netherlands Ministry of Finance, *Continuity and Renewal, Report of the Study Group on Tax Reform*, 2010; IMF Staff Discussion Note, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 3 May, 2011, www.imf.org; H Ev 166.

1689For a discussion, see HQ 14. There are a number of ways of calculating the allowance, for instance it could be based on the value of equity multiplied by a specific rate of return (possibly based on gilt yields). See also H Ev 160.

1690Institute for Fiscal Studies, *Mirrlees Review*, 13 September 2011, www.ifs.org.uk

1691See oral evidence taken before the House of Lords Economic Affairs Committee on 23 April 2013, Qq 1-4.

1692H Ev 166

reform.”¹⁶⁹³ In addition, research by the IMF has suggested that for the very largest banks, “large reforms would be needed to have a marked effect.”¹⁶⁹⁴

1023. For the reasons outlined above, introducing a CBIT unilaterally would not be an attractive option. By contrast, the ACE could have benefits beyond achieving tax neutrality. As Professor Devereux explained:

Very broadly, taking international things into account, giving an extra relief for equity and leaving the tax rate as it is makes the UK more attractive. Disallowing interest will make the UK less attractive for banks locating and doing their business here. There are intermediate positions, and one may change the tax rate as well, but I think that the key issue in terms of which direction to go is whether we are making the UK more or less attractive to international banks to locate their business here.¹⁶⁹⁵

1024. Rebalancing the tax system by introducing an ACE without any offset elsewhere would inevitably have cost implications and would reduce companies’ tax bills. According to IMF estimates, applying an ACE to the whole economy would reduce government revenue by 0.5 per cent of GDP.¹⁶⁹⁶ If limited to the banking sector, the Treasury have estimated that the average annual cost to the Exchequer would be in the region of £1 billion. If the scope of the ACE was narrowed still further to include only ‘new equity’ (only applying to the amount of overall increase in equity from the date of reform) the cost would be closer to £100 million per annum.¹⁶⁹⁷

1025. The cost of introducing an ACE for the banking sector could be mitigated by increasing the rate of the Bank Levy, an annual charge which is levied on certain equity and liabilities of banks and building societies.¹⁶⁹⁸ There is an argument to say that introducing an ACE alongside the Bank Levy would in fact address both tax and non-tax incentives for banks to leverage highly:

There are non-tax incentives for banks to favour debt over equity. If the tax distortion in favour of debt is removed through an ACE, an argument can still be made for the Bank Levy to counter these non-tax incentives in favour of debt.¹⁶⁹⁹

1026. While there are likely to be winners and losers within the banking sector from any tax reform, the Commission recommends that the potential financial stability benefits afforded by a neutral tax system are sufficiently important that the Government should consult on whether to introduce a limited form of an Allowance for Corporate Equity

1693H Ev 167

1694IMF Working Paper, *Debt, Taxes and Banks*, February 2012, www.imf.org

1695HQ 3 [Professor Devereux]

1696See H Ev 166; Ruud A. De Mooij and Michael P. Devereux, “Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms”, *International Tax and Public Finance*, vol 18, issue 1 (2011). Mooij and Devereux estimated the whole economy cost to be 0.3 per cent of GDP.

1697See H Ev 247. Costs if available only to banks subject to the UK bank levy would be £0.8bn and £80m respectively.

1698A full offset would require an estimated additional 5 basis points on the rate of the Bank Levy, taking it to 0.180 per cent. Alternatively, “offsetting the costs of the ACE through a higher rate of corporation tax may be a more logical approach.” See H Ev 248; HMRC, *Bank Levy Manual*, BLM000500, 9 December 2010, www.hmrc.gov.uk.

1699H Ev 162

for the regulated banking sector alongside an uplift in the Bank Levy to offset the cost to the Exchequer in full.

Accounting for regulatory needs

Introduction

1027. We noted in Chapter 3 that auditors failed to provide a last line of defence against banks' questionable reporting on their own businesses, and that accounting rules encourage pro-cyclicality in the banking system because the nature of accounts is to look backwards.¹⁷⁰⁰

1028. Accounting standards are governed by EU legislation, which incorporates international rules. Compliance with International Financial Reporting Standards (IFRS) has been mandatory for UK listed companies, including banks, since 2005.¹⁷⁰¹ We received a great deal of evidence regarding general deficiencies in IFRS. Beyond considering issues particularly relevant to banks, such as valuation of assets, the evidence questioned whether a focus on convergence with US accounting standards and a desire for consistent application of IFRS led to an over-emphasis on compliance and box-ticking, at the expense of professional judgement and willingness to correct emerging issues. Concerns were also raised more generally about whether IFRS allows accounts to be sufficiently prudent to provide a true and fair view of a company's financial position, which is a legal requirement under the Companies Act.¹⁷⁰² Prudence is further considered later in this chapter. There is clearly widespread concern about IFRS and the method by which it is introduced into EU law. As this is beyond the scope of this Report, this may be an issue which the House of Lords Economic Affairs Committee or the Treasury Committee wish to consider in due course.

1029. Given that governance of accounting standards is largely carried out at an international level and that there are very limited opportunities for UK accounting standard-setters to make unilateral changes to accounting standards, we have focused on practical ways for banks to provide better accounting information to regulators and investors. Banks' implementation of accounting rules relating to valuation of assets including prudence, modelling of impairment reserves and the use of fair value have implications for financial stability and investor confidence.¹⁷⁰³ Problems with these rules have not yet been resolved despite ongoing debate within the accounting profession since the onset of the financial crisis, partly due to the complex process by which IFRS is adopted into EU law.

¹⁷⁰⁰See paragraphs 176-1 80.

¹⁷⁰¹Use of those IFRS which have been adopted into EU law is mandatory for the consolidated accounts of EU listed companies whose securities are admitted to trading on a regulated market.

¹⁷⁰²HQq 133, 309, 315 [Roger Marshall], 389; ICAEW, *Audit of banks: lessons from the crisis*, June 2010, www.icaew.com

¹⁷⁰³The Pozen Report in the US noted that all valuation models are subject to reliability concerns, but that there are particular problems where a lack of quoted prices in respect of fair valuation leads to second-guessing. Advisory Committee on improvements to Financial Reporting, *Final Report*, 1 August 2008, www.sec.gov

1030. The Commission recognises that the way in which IFRS affects banks cannot be solved by UK accounting standard-setters alone. Reform of accounting standards should better reflect the needs of bank regulators and investors, including the process by which IFRS is adopted into EU law, and should be a priority for the Government in relevant international negotiations.

Accounting issues particular to banks

1031. Accounting priorities for the banking sector focus on the appropriate valuation of assets and liabilities and the impact of this on prudential capital requirements. We have considered what practical measures can be introduced to provide better accounting information on valuations.

1032. IFRS can result in pro-cyclical valuations of bank assets and liabilities. In apparently positive economic conditions this causes bank assets to be overstated (and liabilities to be understated) and allows banks to appear to be meeting regulatory capital requirements while their capital buffers may in fact be grossly inadequate.¹⁷⁰⁴ In particular, bank models used to recognise a decrease in the value of a loan asset within the accounts under IFRS are based on ‘incurred-losses’ and do not take account of expected losses. Most written evidence agreed that loss provisioning by banks would have been more conservative if an expected-loss model, which provides for impairment once anticipated, had been in place.¹⁷⁰⁵ The International Accounting Standards Board (IASB) acknowledged that this criticism was “partially justified” and has been developing such a model in response.¹⁷⁰⁶ This will require banks to take some provisioning for all assets, even if they are not impaired.¹⁷⁰⁷ However, even if the expected loss model had been in place from 2005, this would not have prevented under-provisioning entirely—the problem was that the scale of losses was entirely unexpected. As the IASB pointed out:

The clue is in the name of this as an expected loss model. Expectations will be different among different people and they will probably be wrong. We need methods which underpin consistent expected loss provisions or else we will just be back where we started.¹⁷⁰⁸

1033. The introduction of an expected-loss model for valuation of debt assets held to maturity might represent a beneficial change to international accounting standards. However, we are concerned at the slow pace of consideration of this change and the particular effect this has on investor confidence in the balance sheets of banks. The Commission therefore recommends that the FRC prioritise an early decision on the expected-loss model for the banking sector in EU negotiations.

¹⁷⁰⁴Bank of England, *Record of the interim Financial Policy Committee Meeting held on 21 November 2012*, 4 December 2012, www.bankofengland.co.uk

¹⁷⁰⁵See for example, H Ev 92, 113, 132

¹⁷⁰⁶H Ev 132

¹⁷⁰⁷HQ 75. The expected-loss model is not yet part of IFRS—introduction of the accounting standard has been delayed by the EU adoption process.

¹⁷⁰⁸HQ 131

A separate accounting regime

1034. Users of bank financial statements come from a broad range of backgrounds, including investors, regulators and tax authorities, and their needs can be quite different. For example, Richard Murphy of Tax Research LLP commented that “accounting for tax [...] is profoundly misleading”, due to the dislocation between the tax charge in the accounts and cash tax paid.¹⁷⁰⁹ Regulators have consistently spoken out about their dissatisfaction with IFRS,¹⁷¹⁰ with Andrew Bailey telling the Treasury Committee that “we disagree with the accounting standards, frankly, in terms of their lack of forward-looking loss provisioning”.¹⁷¹¹ The Financial Reporting Council (FRC) and other stakeholders also raised concerns that the principle of prudence, described in the 2001 Framework for the Preparation of Financial Statements as “the inclusion of a degree of caution in the exercise of judgements needed in making the estimates required under conditions of uncertainty such that assets or income are not overstated and liabilities or expenses are not understated”, is no longer part of the IASB’s Conceptual Framework (introduced in 2010).¹⁷¹²

1035. The accounting profession has recognised that the concept of neutrality (“trying to get the right answer without bias”) as introduced by the IASB’s Conceptual Framework does not align with the more prudent approach to capital taken by regulators.¹⁷¹³ However, they argue that neutrality is preferable to excessive conservatism, sometimes interpreted as ‘prudence’.¹⁷¹⁴ Professor Prem Sikka of the Centre for Global Accountability at the University of Essex, suggested that the particular needs of regulators, such as a more prudent valuation framework, may not be reconcilable with current accounting philosophy:

It may well be that the regulators may have to specify different things[...]Otherwise the danger is that we would expect one set of accounts to provide a whole lot of different things that cannot actually be done.¹⁷¹⁵

This suggestion raises the question of whether there should be a separate accounting regime for banks. The benefit of such an approach would be to present a more prudent view to shareholders and others of the financial position of the bank. There are, however, a number of legitimate concerns with such a proposal, including definition of boundaries, encouraging arbitrage and the risk of a growing shadow banking sector.¹⁷¹⁶ Indeed, the

1709H Ev 272

1710HQ 101

1711Oral evidence taken before the Treasury Committee on 15 January 2013, HC (2012–13) 873, Q 54

1712H Ev 140-141, 235, 294

1713Introduced in 2010. This replaced specific reference to ‘prudence’ with the concept of ‘neutrality’. Prudence is argued to have been retained in the actual accounting standards themselves. See HQ 386.

1714H Ev 76

1715HQ 48

1716See, for example H Ev 105, 123, 141

Pozen Report to the United States Securities and Exchange Commission recommended that industry-specific accounting standards be eliminated.¹⁷¹⁷

1036. Another option would be for separate accounts to be provided to the regulator, in addition to standard IFRS accounts. This was advocated by Antonio Horta-Osario, who pointed to the system in Brazil, Portugal and Spain, where regulators set particular accounting standards for banks which are then reconciled to IFRS accounting standards in the financial statements:

For example, in Brazil, Portugal or Spain the central bank—the regulator—decides the accounting standards [...] What I do think is that when you are speaking about banks, you should not want a mark-to-market view to be taken for the definition of capital, because I think that for a capital definition you would take a prudent view and not a mark-to-market view. By definition, a mark-to-market view is a central view, and a prudent view is not a mark-to-market view. In my opinion, the way to solve this problem is not to change IFRS but to consider whether banks should not calculate their capital according to a different set of rules, as you do, for example, for the purposes of tax calculation. When you calculate tax, you do not use IFRS; you use the HMRC tax system. Why would you not consider having different accounting standards rules for the purposes of capital calculation—one that is prudent, not mark-to-market? Then you could, in the accounts of the banks, ask the banks to publish the reconciliation between capital definition in prudent accounting standards defined by the regulator, and IFRS accounting standards, which are the ones used by the investors. This is already done in several countries in the world, such as Brazil and Spain.¹⁷¹⁸

This could be an opportunity for action to be taken on a UK level to achieve the practical outcomes which would otherwise be delayed by waiting for international agreement on IFRS. We note, however, that Dr Carney does not currently favour a separate set of accounts. He told the Treasury Committee:

although what I would say is that, and I suppose I could be convinced otherwise over time but I do start from a position where I prefer to not have two sets of accounts, a regulatory set of accounts and a public set of accounts.¹⁷¹⁹

1037. The regulators have compensated for deficiencies in accounting standards by applying their own more conservative standards.¹⁷²⁰ As Andy Haldane explained:

Even if accounting standards are not quite in the right place, we, as regulators, can impose our own regulatory filters, recognising more provisions early on. Indeed, the

1717Advisory Committee on improvements to Financial Reporting, *Final Report*, 1 August 2008, www.sec.gov

1718Q 3497

1719Treasury Committee, Eight Report of Session 2012–13, *Appointment of Dr Mark Carney as Governor of the Bank of England*, HC 944, Q 127

1720For a fuller discussion, see Bank of England, *Accounting for Bank Uncertainty speech*, Andy Haldane, 19 December 2011, www.bankofengland.co.uk

[...] FPC[...] asked that banks look through and provision more on a forward-looking basis than current accounting standards permitted.¹⁷²¹

The slow pace of change in IFRS means that there may be other areas where regulators require a deeper understanding than IFRS accounts provide and where enhanced reporting to regulators would be of benefit. These include the true extent of expected credit and other losses and how they are derived; the quality of a bank's earnings and the extent and nature of accounting uncertainty (including the use of prudent valuations). One of the ways in which UK regulators have already sought to address deficiencies in IFRS is by requiring banks to complete a prudent valuation return for regulatory purposes. This requirement recognises that the approach taken by banks to fair valuing assets can vary substantially and that the fair values in firms' annual reports do not provide substantial information on the degree of uncertainty in the valuations of financial instruments, such as derivatives.¹⁷²² There are also numerous regulatory returns that must be completed by banks and the introduction of Common Reporting (COREP)¹⁷²³ with CRD IV will require further specialised reporting to regulators.

1038. Sir David Tweedie, in a recent letter to *The Financial Times*, discussed some of these issues.¹⁷²⁴ In that letter Sir David said he was not "persuaded by arguments in favour of a separate accounting regime for banks" and added:

Many large corporates have a greater exposure to financial instruments than a mid-tier bank. Introducing a separate accounting regime for only certain types of entities acting as financial institutions risks exacerbating the problem of a shadow banking system.

Sir David also differentiated between the concept of accounting profit vis-a-vis regulatory profit:

no accounting standard can or should seek to define what element of profits can be distributed. That is quite rightly the job of regulators, while transparency is the concern of standard-setters. While I was chairman of the IASB, I recommended to regulators the notion of "regulatory income" (based on accounting profit with both income based on estimated prices and a certain percentage of profit deducted) on which distributions and compensation could then be based.¹⁷²⁵

Sir David expanded on this point in evidence:

in the accounts you show the accounting profit, and then you say, 'Now, regulators want a certain amount held back as an undistributable reserve.' That gets deducted from profit in what we called regulatory income. You could also deduct from that all income from modelled fair values, and then you end up with a level that is suitable for distributions, compensation calculations and so on. That is different from the

1721HQ 103

1722See FSA, *Proposed Regulatory Prudent Valuation Return*, CP 11/30, December 2011, p 5, www.fsa.gov.uk

1723H Ev 175

1724"Benefits of IFRS far outweigh the loss of national standards", *The Financial times*, 29 March 2012, www.ft.com

1725*Ibid.*

accounting profit, because once you start bringing in phoney provisions, you have a problem, whereas what we are saying is, ‘You can get exactly what you want,’ which is retaining profit by having undistributable reserves, and that does not distort—it is clear—and that can be settled by the regulators.¹⁷²⁶

1039. While we recognise the risk of ever more complex and burdensome accounting requirements, flaws in IFRS mean that the current system is not fit for regulators’ purposes. The Commission recommends that non-EU mandated regulatory returns be combined, with any other accounting requirements needed, to create a separate set of accounts for regulators according to specified, prudent principles set by the regulator. This second set of accounts should be externally audited and the Commission recommends that a statutory duty to regulators be placed upon auditors in respect of these accounts. Where there is a public interest for these accounts to be published, the regulator should have a legal power to direct that they (or where appropriate, abbreviated accounts) are included in the financial statements, alongside a reconciliation to the IFRS accounts.

Clearer auditors’ reports

1040. The purpose of an auditor’s report is to assure the shareholders that the financial statements represent a true and fair view of the business.¹⁷²⁷ This is particularly important for banks, given the uncertainties involved in valuing their balance sheets and the potentially catastrophic consequences if banks fail. However, while a great deal of work is carried out during an audit, the typical audit report consists of ‘boilerplate’ statements which add little to shareholders’ understanding. The Institute of Chartered Accountants for England & Wales (ICAEW) commented:

The responsibilities of auditors for reporting on the front section of the financial statements are currently limited. Auditors read this information and must report if the information provided is inconsistent with the financial statements or contains material the auditors know to be untrue. Annual reports have expanded over the years and banks and other reporting entities provide significantly more information in the front section of annual reports. The scope of the audit report, by contrast, has remained relatively static, being largely focused on the financial statements. It may be time to reassess this.¹⁷²⁸

1041. A public debate about the format and scope of the audit report is already under way, and the International Auditing and Assurance Standards Board (IAASB) recently considered a number of ways in which it might be improved.¹⁷²⁹ Andy Haldane suggested that an alternative to the existing format should be:

[a] more graduated approach to scoring and to evaluating solvency than the binary qualifier [...] so that there is a way for the auditor to convey a going concern without

1726HQ 402

1727FRC, *Implementing the Recommendations of the Sharman Panel*, January 2013, www.frc.org.uk

1728ICAEW, *Audit of banks: lessons from the crisis*, June 2010, p 11, www.icaew.com

1729International Auditing and Assurance Standards Board, *Improving the Auditor’s Report*, 21 June 2012

pressing a button that flashes a big red light [...] in principle it would be better to provide a spectrum of views on the health of the balance sheet, rather than this black-or-white binary distinction.¹⁷³⁰

Professor Mike Power of the London School of Economics has observed that “many internal auditors grade their findings, and privately external auditors do this. So the knowledge and capability exists.”¹⁷³¹ However, there are concerns that a grading system would not achieve the objective sought and could lead to problems currently associated with qualified opinions. For banks, the risks are particularly severe, the Sharman Report noting that “in practice any signalling of material uncertainties about their going concern may trigger a liquidity shock and potentially a run on the bank.”¹⁷³² However, it is dangerous to stifle what may be well-founded concerns about bank solvency for fear of causing a panic.

1042. An alternative to a grading system would be an enhanced audit report, or auditor commentary. Such a commentary could enable auditors to provide a more nuanced view of the business and present more qualitative information to shareholders. This proposal has received support, particularly for the purposes of signposting important matters in the accounts.¹⁷³³ While there seems to be an international consensus that auditors need to provide better information, there is no agreement on the best way for them to do so, with different countries having pursued different approaches.¹⁷³⁴ We note that the FRC is currently consulting on the content of the auditor’s report and support the FRC’s efforts to encourage better communication between the Audit Committee and external auditor, recognising the importance of strong corporate governance by the Audit Committee.¹⁷³⁵ **An enhanced auditor commentary would benefit investors and other users of financial statements. We welcome the IAASB’s work to develop a model for best practice. However, we consider that subjective matters of valuation, risk and remuneration, amongst other key judgement areas, are so crucial to investors’ understanding of a bank’s business model that an upfront, independent opinion would be beneficial. The Commission therefore recommends inclusion of specific commentary on these areas in auditors’ reports on banks’ accounts.**

1730HQq 108, 110

1731H Ev 230

1732The Sharman Inquiry, *Going Concern and Liquidity Risks: Lessons for Companies and Auditors, Final Report and Recommendations of the Panel of Inquiry*, June 2012, www.frc.org.uk; H Ev 293, 335

1733H Ev 94

1734The French approach to audit requires auditors by statute to justify their assessments, or give reasons for the opinion issued. See, for example, H Ev 265; CNCC, *Study on the perception of the statutory auditor’s “justification of assessments”*, 3 May 2011, www.cncc.fr. In Germany, the management report is audited alongside a review of the narrative part of the financial statements, which includes forward-looking information (H Ev 79). The Australian model requires a separate opinion on the Remuneration Report (IAASB, *Feedback Statement - The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications*, January 2012). In the UK, the FRC has taken a different approach by focusing on the feedback loop between the Audit Committee and the external auditor and ensuring that both fulfil existing duties to the shareholders (see HQ152 and Financial Reporting Council, *UK Stewardship Code*, September 2012).

1735Launched on 4 February, 2013. This covers commentary on ‘risks of material misstatement’, an explanation on ‘materiality’ and a summary of how the scope of the audit corresponds to disclosed risk. See FRC, *Implementing the Recommendations of the Sharman Panel*, January 2013, www.frc.org.uk

It's good to talk

1043. Earlier in this chapter we concluded that there should be better alignment between the tax system and regulatory objectives. There appears to be more that could be done to improve communication between bank regulators, the tax authorities and auditors in order to reduce the opportunity for banks to game differences in rules and regulations. Banks are currently able to take advantage from the lack of dialogue. As the ICAEW noted: “businesses in general, and banks in particular, are always likely to seek opportunities for arbitrage where there are differences in prices or in regulation [...] we believe that [...] it would be better to focus on the regulatory, tax and financial reporting systems [...] HMRC, the FSA and FRC could also more closely co-ordinate their approach to the largest banks.”¹⁷³⁶

1044. Currently, there is an information gateway between HMRC and the regulator but the range of information which they are allowed to share is narrow.¹⁷³⁷ The Government told the Commission that:

This inevitably limits the regulator’s ability to discuss institution specific issues with HMRC, including circumstances where this would have benefits [...] In a number of enquiries, banks have claimed that their reason for undertaking a transaction in a particular way or their purpose for being party to [a] transaction was for regulatory purposes, but information restrictions mean HMRC has been constrained in its ability to confirm this.¹⁷³⁸

1045. The FSA recognised its lack of tax expertise and conceded that tax issues had not been “a significant point of focus” for them in their prudential supervision of banks.¹⁷³⁹ However, given that the FSA also acknowledged that “much of the complexity in financial structures and at least some of the leverage arises from banks’ efforts to optimise orthogonal tax and regulatory structures simultaneously”, it seems that both bank regulators and supervisors should be paying far more attention to tax issues.¹⁷⁴⁰

1046. There are other areas where regulators have an interest in tax, such as the treatment of deferred tax assets for regulatory capital purposes. As the OECD has pointed out:

Banks have a key non-tax interest in ensuring that they receive full tax relief for commercial losses, as tax losses can in some circumstances count towards regulatory capital available to support their business. There is some evidence of tax planning by banks primarily aimed at maximising recognition of tax losses for regulatory capital, rather than tax/cash-flow, purposes.¹⁷⁴¹

1736H Ev 91

1737Financial Services and Markets Act 2000, Section 12 (2); Disclosure of Confidential Information Regulations 2001

1738H Ev 174

1739H Ev 134, 211

1740H Ev 211

1741OECD, *Addressing Tax Risks Involving Bank Losses*, 15 September 2010, www.oecd.org; there are due to be changes in the way deferred tax assets (roughly speaking, stockpiled tax losses) can count towards regulatory capital in 2015. This paper also estimated that globally, the stock of bank tax losses was in excess of \$700 billion. To the extent that deferred tax assets cannot be used for regulatory purposes, banks are likely to seek to convert them into cash benefit.

KPMG told us that this was one particular area where closer dialogue between the PRA and HMRC would be useful, commenting that “regular dialogue between HMRC and UK regulators would be sensible and desirable; our impression is that such dialogue is limited at present.”¹⁷⁴² The Treasury observed that:

Having easily accessible gateways for information and knowledge sharing would help both bodies to identify any tax and regulatory arbitrage, and take necessary action needed to address this [...] there would also be benefits in terms of ensuring tax rules dovetail appropriately with regulatory requirements [...] to ensure that the consequences of the existing tax rules do not drive behaviours in ways that undermine regulatory objectives.¹⁷⁴³

1047. There are significant areas of overlap in the work of HMRC and the regulators. Rules related to information sharing between authorities are governed by EU law. It is important that confidentiality rules are respected. The Commission recommends that HMRC, PRA and FCA jointly publish a paper setting out how they intend to bring about appropriate useful sharing of information and expertise within the existing rules. The PRA should consider using its powers to commission reports on a specific function of a bank’s business on behalf of HMRC. This might include commissioning reviews on tax risk management and financial transfer pricing. The Commission recommends that the National Audit Office undertake a periodic review of how effectively the PRA uses its powers to promote information sharing.

1048. The House of Lords Economic Affairs Committee described the lack of dialogue between auditors and bank supervisors in the run up to the financial crisis as a “dereliction of duty”. The Committee continued:

Adequate and timely dialogue between bank auditors and supervisors is of the first importance. It is essential not only to enable the auditors to audit more effectively and the supervisors to supervise more effectively, but in particular to overcome the problem caused by the understandable reluctance of auditors to qualify banks' accounts.¹⁷⁴⁴

Witnesses agreed that such dialogue needed to be robust. Paul Sharma, Director of Policy, FSA, said that:

I am quite clear, and the whole senior management designate of the PRA is quite clear, that we cannot be an effective prudential regulator without significant, good, strong, ongoing, timely two-way communication between the auditors and the supervisors. That is why we have acted to put guidance in place.¹⁷⁴⁵

1742H Ev 112

1743H Ev 174

1744 Economic Affairs Committee, Third Report of Session 2010–12, *Auditors: market concentration and their role*, HL Paper 119, para 155; also discussed in Chapter 3 of this Report.

1745HQ 305

This guidance consists of a Code of Practice which sets out the nature of the relationship between supervisor and auditors, the form and frequency of communications and responsibilities and scope for sharing information.¹⁷⁴⁶

1049. Measures are in place to secure the quality of dialogue between regulators and auditors, including a requirement for bilateral meetings.¹⁷⁴⁷ The Government amended the Financial Services Bill to require the PRA to have arrangements for sharing information and opinions with auditors, and to require the Code to be published and laid before Parliament. While this is clearly an improvement, there are concerns that over the passage of time, the practical use of the Code will fall into abeyance.

1050. Some witnesses told us dialogue between regulators and auditors should be made mandatory, as recommended by the House of Lords Economic Affairs Committee. Hans Hoogervorst, Chairman of the IASB agreed that this was “common sense.”¹⁷⁴⁸ Stephen Hadrill, Chief Executive of the FRC, described it as having “no downside” and Paul Sharma agreed “wholeheartedly” that this should be the case.¹⁷⁴⁹

1051. The existing Code recommends that bilateral meetings between supervisors and auditors take place at least on an annual basis, with further bilaterals as necessary when planning audits.¹⁷⁵⁰ David Barnes, Managing Partner of Public Policy at Deloitte, told us that there were precedents for going further than this, and requiring meetings in statute:

in the Banking Act 1987, you had a requirement for auditors to do set pieces of work under the section 39 regime. That forced a number of touch points between the auditors and the regulator: it was not written in stone, but it did almost require the auditors to meet with the regulators, either on a bilateral or a trilateral basis, frequently during the year. When that was abolished, I think in early 2000, there were fewer touch points there, and that, I think, was one of the reasons why the meetings became less regular. They still happened, but they became less regular than they had hitherto been.¹⁷⁵¹

1052. The wider relationship between the supervisor and auditors is clearly key to improving the quality of dialogue. As Tony Clifford, partner at Ernst & Young, told us:

it is not going to be the formal linkages and duties that will make a huge difference. For the dialogue between auditors and regulators to work well, it has to be on an informal basis—and quite often to make sure that the regulator can operate in a way which is timely and can shut the door before the horse has bolted. [...] It might well

1746FSA, *Code of Practice for the relationship between the external auditor and the supervisor*, May 2011, www.fsa.gov.uk

1747PRA, *The relationship between the external auditor and the supervisor: a code of practice*, April 2013, p 2, www.bankofengland.co.uk

1748HQ 94

1749HQ 306

1750PRA, *The relationship between the external auditor and the supervisor: a code of practice*, April 2013, p 4, www.bankofengland.co.uk

1751HQ 205

be just a phone call to say, “We just noticed that one of the screws on one of the hinges is loose.”¹⁷⁵²

Establishing effective dialogue requires a culture of mutual trust, which has been missing in the past. Each side has attributed this fault to the other, with the accounting profession complaining that the information flow is one-way. On the one hand, as the ICAEW pointed out: “while some bilateral meetings provide a frank exchange of views, auditors report other meetings with the FSA where the information flow is one way, with the supervisor listening to insights from the auditor but providing little in exchange.”¹⁷⁵³ On the other hand, the FSA considered that external auditors did not always share some useful information.¹⁷⁵⁴ According to a joint discussion paper issued by the FSA and FRC, this lack of dialogue has led to the situation where:

There have also been occasions where the FSA and a firm’s auditors have been separately encouraging the firm to reconsider an accounting estimate it was proposing to use; had the parties been aware that they shared each other’s concerns, they both might have raised those concerns more forcefully with the firm. This is a good example of how more can be achieved working together rather than working separately. Both parties need to learn that, where there is a concern, the default should be to share the information unless there are restrictions that would prohibit this.¹⁷⁵⁵

The FSA acknowledged that there is a need “to create the right culture among our supervisors and among the auditors such that there is the degree of trust and the degree of urgency so that we get the kind of good quality sharing of information that is absolutely necessary for a modern, effective, prudential regime.”¹⁷⁵⁶

1053. There appears to be general agreement that effective communication between auditors and supervisors is crucial. However, in the past the relationship between supervisors and auditors has been dysfunctional. The Commission recommends that the Court of the Bank of England commission a periodic report on the quality of dialogue between auditors and supervisors. We would expect that for the dialogue to be effective, both the PRA and the FCA would need to meet a bank’s external auditor regularly, and more than the minimum of once a year which is specified by the Code of Practice governing the relationship between the external auditor and the supervisor. This should be required by statute, as recommended by the House of Lords Select Committee on Economic Affairs. Representatives of the audit profession should also have the opportunity to discuss emergent issues that have arisen from their work with banks with the PRA, the FRC and HMRC. We expect that this would require thematic meetings.

1752HQ 209

1753ICAEW, *Audit of banks: lessons from the crisis*, June 2010, www.icaew.com

1754FSA and FRC, *Enhancing the auditor’s contribution to prudential regulation*, June 2010, para 5.13, www.fsa.gov.uk

1755*Ibid.*

1756HQ 298

The new regulatory structure and our approach

1054. Rules are no substitute for good judgement. Improved banking standards require regulators who are willing and able to take action as necessary on the basis of judgement rather than simply following rules or mindlessly collecting data. This requires them to be bolstered by accountability mechanisms that empower them to take difficult decisions when they are needed and give them the opportunity to explain their actions in public. This section considers the structure and powers of the new regulators and how their accountability might be improved.

1055. Regulatory failure played a major role in permitting standards to slip in the banks. This in turn added to the severity of the crisis. The Government has responded with fundamental structural reform of financial regulation. The Financial Services Act 2012 concentrated macro- and micro-prudential regulatory responsibility at the Bank of England, with the creation of:

- the Financial Policy Committee—a subcommittee of the Court of the Bank—which is responsible for identifying and monitoring, and taking action to remove or reduce, systemic risks; and
- the Prudential Regulation Authority (PRA)—a subsidiary of the Bank of England—which prudentially regulates banks, insurers and major investment firms.

Conduct regulation now lies with the Financial Conduct Authority (FCA), separate from the Bank.

1056. The new regulatory structure aims to address conflicts that arose from a single regulatory body being responsible for both prudential and conduct regulation. Michael Foot, a former Managing Director at the FSA, described some of the problems of the former regime:

We had conduct of business and prudential people in the same building arguing like cat and dog because they had never been together before and whether it was mortgage endowments or whatever the issue was, there was a prudential aspect and a conduct of business aspect.¹⁷⁵⁷

1057. Under the tripartite arrangements put in place upon the creation of the FSA in the late 1990s, involving the FSA, the Bank of England and the Treasury, the different parties adopted a ‘silo’ approach focusing on their areas of responsibility and failing to engage with one another sufficiently. Lord Turner, Chairman of the FSA until March 2013, noted that:

The two institutions (Bank and FSA) were so keen to concentrate on their own specific responsibility—the Bank on monetary policy defined around the inflation rate objective, the FSA on the supervision of institutions on an individual case-by-

case basis that, (as Paul Tucker [...] has expressed it)—we left an under lap between us.¹⁷⁵⁸

Although any division of responsibilities may lead to the creation of silos, the new structure should bring benefits from returning prudential supervision to the central bank. As Sir Mervyn King pointed out, “one of the reasons for putting the PRA inside a central bank is to integrate the work of the two institutions more closely”, which should result not only in more effective supervision, but in longer term cost savings.¹⁷⁵⁹ It will be a matter of time to see how well the new structure works. So far there are some encouraging signs. Andrew Bailey, Chief Executive Officer of the PRA and Deputy Governor in the Bank of England for Prudential Regulation, told the Treasury Committee:

Since the introduction of so-called Internal Twin Peaks in the FSA nearly a year ago, I have observed the benefits of the separation leading to a clearer articulation of both prudential and conduct cases in areas where the two naturally come together and can (again, naturally) lead to different preferences for outcomes.¹⁷⁶⁰

1058. However, the new regulatory system gives rise to difficulties of coordination and communication. The former tripartite regulatory structure was found to be inadequate during the Northern Rock crisis, as a result of ‘regulatory underlap’: the bodies involved, the Treasury, the FSA or the Bank of England, did not, even between them, have all the powers that they wanted in order to solve the crisis. While the new structure may have solved this ‘underlap’ problem, it has done so at the risk of overlap, and this is reflected in the overlapping memberships of the policy bodies under the new structure and the governing bodies of the authorities:

- The Governor of the Bank of England sits on the Court of the Bank of England; chairs the Monetary Policy Committee of the Bank of England; chairs the Financial Policy Committee of the Bank of England; and chairs the Prudential Regulation Authority.
- The Deputy Governor for Monetary Policy sits on the Court of the Bank of England, the MPC and the FPC
- The Deputy Governor for Financial Stability sits on the Court of the Bank of England, the MPC, the FPC and the governing body of the PRA.
- The Deputy Governor for Prudential Regulation is chief executive of the PRA. He sits also on the Court of the Bank of England, the FPC and the governing body of the FCA. In addition, the PRA may restrain the FCA from exercising its regulatory powers over PRA-authorized persons if it believes that is necessary to prevent a threat to the stability of the UK financial system or the failure of a PRA-authorized person in a way that would adversely affect the UK financial system (the ‘PRA veto’).

1758FSA, *The financial crisis and the future of financial regulation speech*, Lord Turner, 21 January 2009, www.fsa.gov.uk; Bank of England, *Crisis and Crash: lessons for regulation*, Michael Cohrs, 23 March 2012, www.bankofengland.co.uk

1759Speech by Sir Mervyn King at the Lord Mayor’s dinner for bankers and merchants of the City of London, Mansion House, London, 15 June 2011

1760Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 13, www.bankofengland.co.uk

- The Chief Executive of the FCA sits also on the Financial Policy Committee and the governing body of the PRA.

This has led some former MPC members to argue for simplification. For example, Kate Barker has said that the responsibilities of the FPC should have remained with the Chancellor¹⁷⁶¹, and Dr Sushil Wadhvani has said that the FPC's and MPC's responsibilities would be better performed by one committee.¹⁷⁶²

1059. In the United States, monetary policy is the responsibility of the Federal Open Market Committee, chaired by the Chairman of the Board of Governors of the Federal Reserve System and comprising other members of the Board and other Reserve Bank presidents. There are no external members. Financial stability policy is the responsibility of the recently-created Financial Stability Oversight Council. This is chaired by the Secretary of the Treasury and comprises regulators and nonvoting advisory members. Again, there are no external members. The Chairman of the Board of Governors of the Federal Reserve is the only person who is a member of both bodies.¹⁷⁶³

1060. Reliance on the coordinating ability of key individuals, and their ability to cooperate and work as a team, carries risks, particularly in a crisis. When the credibility of the financial system is on the line a robust system is needed: effective management of a crisis should not depend entirely on the personalities in post.

1061. Six statutory Memoranda of Understanding (MOUs) set out the arrangements for these bodies coordination of their work. The MOUs illustrate the complexity of the new arrangements. The statutory MOUs are:

- between the Bank, including the PRA, and the Treasury re: Financial Crisis Management;
- between the Bank, including the PRA, the Treasury and the Financial Conduct Authority (FCA) re: International Organisations;
- between the Bank, including the PRA, and the FCA re: supervision of Markets and Markets Infrastructure;
- between the FCA and the PRA re: co-ordination;
- between the FCA and the PRA re: supervision of with-profits policies; and
- between the Financial Services Compensation Scheme Ltd (FSCS) and the PRA re: Financial Services Compensation Scheme (FSCS).¹⁷⁶⁴

In addition, a number of non-statutory MOUs are in place.

1761 CentreForum, *Macroeconomic policy: too much autonomy and too little coordination*, August 2012, p 5, www.centreforum.org; Oral evidence taken before the Treasury Committee on 14 May 2013, HC(2013–14) 96-i, Q 277

1762 Oral evidence taken before the Treasury Committee on 23 May 2011, HC (2010–12) 874, Q 143

1763 "Federal Open Market Committee", *Federal Reserve*, 29 January 2013, www.federalreserve.gov; "Financial Stability Oversight Council", *U.S. Department of the Treasury*, 10 April 2013, www.treasury.gov

1764 "Memoranda of Understanding", *Bank of England*, 2013, www.bankofengland.co.uk

1062. Both the crisis management MOU and that between the PRA and FCA on co-ordination will be particularly important. The crisis management MOU is clear in setting out the ultimate responsibility of the Chancellor in a crisis, in line with the Treasury Committee's recommendation. However, the Bank is given "primary operational responsibility" for financial crisis management. In the crisis in 2007–08 there was little effective corporate governance of the Bank's actions by its Court, and this MOU does not mention the Court either. The main conduit for advice to the Chancellor will be the Governor himself. The MOU on co-ordination between the PRA and the FCA sets up arrangements for the two bodies to exchange information on individual firms. For wide-ranging issues that go beyond particular firms, the respective directors of supervision will be responsible for sharing information.¹⁷⁶⁵ There is a mechanism for escalating conflicts between the regulators ultimately to their boards, but not a mechanism for resolving such conflicts. The provisions of this MOU may not, in practice, solve all the problems that the evidence of two separate regulators may create.

1063. The effectiveness of the new structure will require good communication between the PRA and FCA to avoid duplication and unnecessary costs, as well as to ensure that supervisory issues do not fall between the gaps. Conduct issues, in particular, can have significant prudential implications, as demonstrated by the regulatory response to the mis-selling of PPI, where the scale of consumer redress has led to a weakening in banks' capital positions.¹⁷⁶⁶ Despite the formal Memoranda of Understanding, in practice, the effectiveness of the arrangements will rely on strong working level communication.¹⁷⁶⁷

1064. A fundamental change in the structures for the regulation of the financial services sector, including banking, has just come into effect. This has involved a major upheaval for the regulators and the regulated, albeit with a potential for benefits in the future. In view of the radical and recent nature of this upheaval, we have concluded that no purpose would be served by recommending further fundamental changes in regulatory structures hard upon the heels of those recently introduced.

1065. We have focused our consideration and recommendations in this chapter on:

- The objectives of the regulators and the way these might shape their future work;
- The accountability arrangements under the new regulatory structures; and
- The structure of enforcement decision-making;

¹⁷⁶⁵The Lloyds insurance market and with-profits policies have more developed coordination arrangements.

¹⁷⁶⁶Bank of England, *Record of the interim Financial Policy Committee Meeting held on 21 November 2012*, 4 December 2012, p 5, www.bankofengland.co.uk

Regulatory objectives

A PRA competition objective?

1066. The PRA has a statutory objective to promote the safety and soundness of firms. It is required to pursue this primarily by:

- seeking to avoid adverse effects on financial stability; and
- by seeking to minimise adverse effects resulting from disruption to the continuity of financial services that can be caused by the way firms run their business or by their failure.

1067. Unlike the FCA, which has an operational objective to promote competition, the PRA merely has a ‘have regard’ duty with respect to competition, namely to “the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions”.¹⁷⁶⁸ The Treasury Committee, during the passage of the Financial Services Act 2012, called for the PRA to be given a secondary competition objective:

It remains our view that competitive markets need both freedom to exit and freedom to enter. The Bill contains no proposal for specific objectives related to competition for the Prudential Regulation Authority. We recommend that the House of Lords consider amending the Bill to make competition an objective of the Prudential Regulation Authority.¹⁷⁶⁹

1068. Witnesses fell into three camps. Some were in favour of a PRA competition objective, others felt a ‘have regard’ duty was sufficient and struck the correct balance, while a third group felt that even a ‘have regard’ duty would divert the PRA from its core objective, namely promoting financial stability. Sir Donald Cruickshank fell into the first camp. He warned that:

If a regulatory body that is overseeing the activities of a sector of the economy that is central to the operation of the state does not have a competition objective—I am not talking about regulating doctors or nurses or indeed bankers themselves—it is very likely that competition will be muted.¹⁷⁷⁰

Clare Spottiswoode fell into the second camp, but she acknowledged that a ‘have regard’ duty “may or may not be strong enough”. In subsequent written evidence she stressed the importance of ensuring that the PRA’s responsibility to act in a manner which minimised any adverse impact on competition was “strongly embedded in the culture of the PRA, from the top down”.¹⁷⁷¹

¹⁷⁶⁸Financial Services Act 2012, section 6

¹⁷⁶⁹Treasury Committee, First Report of session 2012–2013, *Financial Services Bill*, HC 161, para 57

¹⁷⁷⁰Q 154

¹⁷⁷¹Q 2330; Ev 1337

1069. **The Commission has concluded that the PRA should be given a secondary competition objective. A ‘have regard’ to competition simply does not go nearly far enough. As the experience of the FSA shows, a ‘have regard’ duty in practice means no regard at all. With only a ‘have regard’ duty given to the PRA, the risk is high that it will neglect competition considerations. This would be of great concern, given the potential for prudential requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants. The current legislation strikes an inadequate balance in this area.**

The FCA: too many objectives?

1070. The FCA’s objectives have the appearance of having been designed on the hoof. They have certainly altered considerably from the Government’s original July 2010 proposal for the establishment of a conduct regulator—at that time called, unhelpfully, the Consumer Protection and Markets Authority—with a single primary objective of “ensuring confidence in financial services and markets, with a particular focus on protecting consumers and ensuring market integrity”, balanced by a set of statutory secondary objectives.

1071. The Government has subsequently greatly recast the FCA’s objectives. The Financial Services Act 2012 now gives the FCA a single strategic objective of “ensuring that the relevant markets function well”. This is buttressed by three operational objectives:

- securing an appropriate degree of protection for consumers;
- protecting and enhancing the integrity of the UK financial system; and
- promoting effective competition in the interests of consumers.

The FCA must also, so far as is compatible with acting in a way which advances the consumer protection objective or the integrity objective, discharge its general functions in a way which promotes effective competition in the interests of consumers. The matters to which the FCA may have regard in considering the effectiveness of competition include:

- the needs of different consumers who use or may use those services, including their need for information that enables them to make informed choices;
- the ease with which consumers who may wish to use those services, including consumers in areas affected by social or economic deprivation, can access them;
- the ease with which consumers who obtain those services can change the person from whom they obtain them;
- the ease with which new entrants can enter the market; and
- how far competition is encouraging innovation.

1072. The FCA was given an operational objective relating to competition only after sustained pressure from Parliament. The Treasury Committee, in particular, argued that

the objectives of the FCA should be framed with a view to obtaining simplicity and clarity and expressed concern that “the so-called strategic objective adds nothing to the operational objectives, but may create scope for the operational objectives to be trumped”.¹⁷⁷² To date the Government has not shown a preparedness to reconsider this issue.

1073. Martin Wheatley, Chief Executive of the FCA, implied that the strategic objective added little or nothing to the three operational objectives:

I am not sure that it [the strategic objective] does that much to the three operational objectives. You could argue that promoting effective competition in the interest of consumers and the market, enhancing the integrity of the system and ensuring an appropriate degree of protection encompass everything that is in the phrase “ensuring markets work well”.¹⁷⁷³

Mr Wheatley went on to tell us that he “would be open to a redrafting that keeps us to our core purpose, which is to get proper conduct standards in markets so that consumers get a better deal”.¹⁷⁷⁴ Subsequently Mr Wheatley wrote to us nuancing the answer he had given in oral evidence:

[...] the Government recognised that while the strategic objective should steer the FCA as to the overall aim it is trying to achieve, the operational objectives should be the means by which the FCA discharged its responsibilities. The 2012 Act therefore provides that the FCA should, so far as possible, advance its operational objectives, and act compatibly with the strategic objective. As a result, there are no powers in the 2012 Act which are triggered off the strategic objective—instead those powers can be deployed where the FCA considers it necessary or desirable to do so for the purposes of advancing any of its operational objectives.

At the time the Government was considering the content of the strategic objective the FSA made clear that it would be concerned were the FCA to end up with an objective it could never fulfil. However, we are satisfied that the strategic objective as it currently appears does not leave the FCA exposed in that way.

We also think that, as a statement of the overall outcome society expects of the FCA, the strategic objective is a reasonably good fit to the operational objectives.¹⁷⁷⁵

1074. The case for the FCA to have a strategic objective that can trump the operational objectives. The strategic objective, as the Chief Executive of the FCA initially told us, is embodied in the current operational objectives. The Government has previously argued that the strategic objective will focus the new regulatory culture of the FCA. The opposite is the case. The plethora of strategic and operational objectives sitting alongside a number of duties and ‘have regard’ requirements risks diverting the FCA’s

¹⁷⁷²Treasury Committee, First Report of Session 2012-13, *Financial Services Bill*, HC 161, para 53

¹⁷⁷³Q 4455

¹⁷⁷⁴Q 4457

¹⁷⁷⁵Ev 1249

focus on its core operational objectives. The Commission recommends that the FCA’s strategic objective of “ensuring that the relevant markets function well” be dropped.

Embedding a pro-competition culture at the FCA

1075. We also received evidence which questioned whether the FCA would use its new competition powers effectively. A number of witnesses expressed concern that this was unlikely to happen. Sir Donald Cruickshank argued that the wording of the legislation in this area was flawed:

I can tell you that if the Financial Services Bill becomes an Act in its present form, with that wording for the FCA relative to competition, it will have a minimal impact on the decisions of the FCA, because it is not a primary objective—it is qualified. Through that sentence, Sir Humphrey lives, because there are three qualifying phrases before the word “competition” is mentioned. In other words, if anything is clear, it is that you will make this objective subservient to any other objective you may possibly have, or consider that you have. That is how I would read it. It is not far short of saying just “have regard to”.¹⁷⁷⁶

We asked competition economists about how seriously the FCA would take its competition remit. They expressed concern:

- that the FCA would continue to use regulation and not competition as its primary tool;
- that the FCA lacked a pro-competition culture; and
- at the lack of people at the FCA with specialist skills in competition economics.

Clare Spottiswoode told us that she did not see much sign that the FCA was going to employ its competition powers:

I do not see many signs that the FCA is taking this seriously, which I regret very deeply [...] The FSA, as it becomes the FCA, is in great danger of going in many ways and in many wrong directions, which is another reason why I pushed that [competition] duty so hard. I thought that it would force the FCA to act differently, but there is no sign of its doing so yet.¹⁷⁷⁷

When asked how best to ensure that the FCA took competition seriously, she told us:

By tackling the FCA and saying, “How are you tackling the competition duty and making sure that it is embedded in everything that you do? When you look at introducing a rule, have you looked at a competition way of creating a better outcome first?” It just does not think that way. It is not the way in which it appears to think. It is not that it is not willing; it is just that it does not have any people there who have ever worked in this area.¹⁷⁷⁸

1776Q 150

1777Q 2325

1778Q 2326

1076. Diane Coyle concurred. She told us that “regulators tend to regulate and they do not think about competition as a tool that they can use”.¹⁷⁷⁹ John Fingleton also stressed this point: “when you run a competition agency, you are probably over-confident about the ability of competition to get results in markets, but when you are a regulator, you are probably over-confident about the ability of regulation to solve every problem”. Mr Fingleton went on to argue that:

What you want in a sector regulator is very strong incentives to use the market and to use competition first to achieve the objectives and to back that up with regulation where needed. It is very important that the FCA sees competition as a positive tool that will achieve all of its other objectives rather than simply as a residual matter at the end of having regulated the market—“Well, do we have enough competition?”

It is that fundamental change in attitude from what the FSA has done that is going to be essential if the FCA is to achieve its objective. The way forward document, the one with the funny name that was put out in November, used some of the right language, but I also detected in there a sense in the FCA that there might be a tension between consumer protection and competition. In fact, for the most part, they are complementary. Exploiting those complementarities and seeing them will be important. I think that the competition duty is important, as is getting it inside the culture of the organisation. There is a huge challenge for the leadership of the FCA to create that skill set and that attitude inside an organisation the historical culture of which has been to regulate rather than to think about how you get competition to deliver your objectives.¹⁷⁸⁰

1077. Mr Wheatley defended himself against accusations that the FCA did not take competition seriously, telling us that “Well, she [Clare Spottiswoode] is correct in terms of signs. There may not be visible signs, because we are in the process of building a capability. Until we have built some capability we are not doing a lot of things very actively in the market to use that competition power”.¹⁷⁸¹ The FCA’s chairman John Griffith-Jones told the Treasury Committee that the FSA had not previously had a competition objective, and that the FCA would therefore have to concentrate to make sure that competition objective was given as much attention as the others.¹⁷⁸²

1078. It is too early to assess how the FCA is using its competition powers and whether it is using them effectively. However, we are concerned that, for a variety of reasons, the FCA could fail to deploy its new competition powers to full effect. The Commission notes that the leadership of the FCA has stressed that it takes competition seriously and intends to use its powers in this area extensively. This is very welcome. The FCA must—as a matter of priority—embed a robust pro-competition culture which looks to competition as a primary mechanism to improve standards and consumer outcomes.

1779Q 2327

1780Q 2328

1781Q 4448

1782Uncorrected transcript of oral evidence taken before the Treasury Committee on 6 November 2012, HC (2012–13) 721, Q 3

Regulatory accountability

Introduction

1079. One of the themes of our work, and one of the crucial lessons from recent as well as less recent history, is that the good intentions of regulators can fail to translate into a consistent pattern of action when faced with pressure particularly from within the banking sector and outside. This happened at times during the early stages of the crisis, as was noted in the Treasury Committee Report *The run on the Rock*, which referred to “a significant failure of the Tripartite arrangements” in September 2007.¹⁷⁸³ **A change of approach needs to be deeply embedded in the regulatory culture if it is to prove enduring. Regulators, too, have interests. They can all too easily fall back, or be forced back, on to a narrow interpretation of their statutory responsibilities, indulge in turf battles, or concentrate on avoiding blame. If regulators are to be subject to the correct incentives, and are to proceed in the knowledge that their future decisions will not be without consequence, it is vital to create the appropriate structures of accountability for the regulators.**

1080. The new regulatory structure is considerably more complex than the previous one, principally because of the substantial additional responsibilities given to the Bank of England, with the creation of the FPC and the PRA. The former is a sub-committee of the Court, and the latter a subsidiary of the Bank itself. This new structure creates challenges for the governance of the Bank. It also requires improved accountability structures that take account of the new structures.

1081. The financial crisis has highlighted the need for greater transparency to ensure that the regulator can be held to account, not least because it may help to counter the long-run pro-cyclicality of regulation to which we referred in Chapter 9. Andrew Bailey has acknowledged that the financial crisis provided a stark reminder of the public interest in the performance of banks and that the Bank/PRA will “need to explain its decisions more fully to Parliament than has been the case with some regulators, for example the Financial Services Authority”¹⁷⁸⁴. He noted in written evidence that:

[...] in spite of confidentiality concerns, there will need to be much greater transparency than in the past. All participants will need to live with this and accept that the world will not be the same again. That said, there are of course limits to transparency where commercial confidence is at issue, and indeed there are other legal requirements that limit open disclosure. I would therefore suggest that the Committee considers how it could take evidence in confidence.¹⁷⁸⁵

¹⁷⁸³Treasury Committee, Fifth Report of Session 2007–08, *The run on the Rock*, HC 56, para 276

¹⁷⁸⁴Written evidence from Andrew Bailey to the Treasury Committee, March 2013, p 17, www.bankofengland.co.uk

¹⁷⁸⁵*Ibid.* p 16

A better run Bank of England

1082. Although there have been substantial increases in the Bank of England's responsibilities, its corporate governance remains largely untouched by reform. Despite the creation of the new Oversight Committee—a sub-committee of the Court of the Bank of England—which is discussed below, the Bank's governance structures remain well short of what is expected in a modern institution, whether in the public or the private sector.

1083. The Governor of the Bank's own central position is greatly enhanced by the Financial Services Act 2012. He now also chairs the Financial Policy Committee and the Prudential Regulation Authority. The Bank's hierarchical structure, with him at the apex, remains—even if the new Governor, Dr Mark Carney, were to bring a more consensual leadership style, successors may revert to an autocratic style if the structure remains unchanged. The Governor remains a single institutional point of systemic risk in the governance arrangements.

1084. The MPC's accountability to Parliament is laid down in remit letters from the Treasury to the Bank of England. For example, the most recent remit of 20 March 2013 states that “The Bank will be accountable to Parliament through regular reports and evidence given to the Treasury Committee.”¹⁷⁸⁶

1085. The FPC's accountability is “through its publication of the twice annual Financial Stability Reports (FSR) and evidence given to the Treasury Committee”,¹⁷⁸⁷ which holds hearings with FPC members on their appointment and reappointment, and judges them against the criteria of professional competence and personal independence. It also hears oral evidence in public from FPC members, including on each occasion some external members, following the six-monthly Financial Stability Reports. New Governors and Deputy Governors also have appointment hearings with the Treasury Committee: in the case of the next Governor Mark Carney, this took place well before he took up his duties.

1086. The hierarchical structure and culture of the Bank, the wide-ranging power of the Governor, and the fact that Bank executives were in the majority on the MPC and the FPC, could give rise to the risk of ‘groupthink’ and a lack of challenge within the institution.¹⁷⁸⁸ The Committee made recommendations about the Bank's Committees, including that the

1786 Letter from the Chancellor of the Exchequer to the Governor of the Bank of England regarding the remit for the Monetary Policy Committee, 20 March 2013, www.hm-treasury.gov.uk. Accountability is ensured by the following means:

New and re-appointed members of the FPC—both Bank executives and external members—are questioned upon their appointment, and the Treasury Committee publishes its conclusions as to whether it is satisfied with the individual's professional competence and personal independence;

The Committee hears oral evidence in public from MPC members following the quarterly Inflation Reports, when the Committee is able to question each member individually about their views and voting record. The Committee aims to see all MPC members at least once a year;

MPC members submit annual reports on their activities and views.

1787 Letter from the Chancellor of the Exchequer to the Governor of the Bank of England, 30 April 2013, www.hm-treasury.gov.uk

1788 Treasury Committee, Twenty-first Report of Session 2010–12, *Accountability of the Bank of England*, HC 874, paras 94–104

MPC and FPC should both have a majority of external members.¹⁷⁸⁹ Even more importantly, it concluded that improvements to the governance of the Bank required the transformation of the structure and role of the Court of the Bank of England.

1087. The Bank of England has been governed, at least in theory, by its Court of Directors since it was established in 1694. The Court is responsible for managing the affairs of the Bank, other than the formulation of monetary policy, which is the responsibility of the MPC. The Court's responsibilities are set out in the Bank of England Act 1998. They include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of its resources. The Bank has a statutory objective to "protect and enhance the stability of the financial system of the United Kingdom". The Court, consulting the Treasury and the Financial Policy Committee, determines the Bank's strategy in relation to that objective.

1088. The 13 members of the Court are appointed by the Crown. There are four executive members: the Governor and the three Deputy Governors responsible for Monetary Policy, Financial Stability and Prudential Regulation. The remainder are non-executive directors, and currently include: the Chairman of Court, Sir David Lees, former Chairman of Tate and Lyle and former Chairman and Chief Executive of GKN; Sir Roger Carr, the Deputy Chairman of Court and Senior Independent Non-Executive Director, who is Chairman of Centrica plc; and Dave Prentis, the General Secretary of UNISON.¹⁷⁹⁰ The Court delegates to the Governor the day-to-day management of the Bank, including the discharge of statutory functions, while reserving certain key decisions to itself.¹⁷⁹¹ Under present legislation, the Court of the Bank of England could never fully replicate the functions of a private sector board, given the exclusive policy responsibility given by statute to the MPC rather than to the Court.

1089. The central recommendation of the Treasury Committee's Report subsequently supported by the Joint Committee on the Financial Services Bill¹⁷⁹² on the Accountability of the Bank of England was that the anachronistic Court of the Bank be transformed into a Board effective enough to exercise meaningful governance:

- the Board of the Bank should be responsible for conducting ex-post reviews of the Bank's performance in the prudential and monetary policy fields normally not less than a year after the period to be reviewed. This would be consistent with avoiding second guessing at the time of the policy decision. The reviews should among other things enable lessons for the future to be learnt, on which the Court should be expected to form a judgement. There should be no presumption that the commissioning of a review implied that the episode or function in question had been badly managed: successes and failures should be reviewed alike. It would be a matter for the Board itself

¹⁷⁸⁹Treasury Committee, Twenty-first Report of Session 2010–12, *Accountability of the Bank of England*, HC 874, para 103

¹⁷⁹⁰"The Court of Directors", *Bank of England*, April 2013, www.bankofengland.co.uk

¹⁷⁹¹Bank of England, *Governance of the Bank including matters reserved to Court*, 13 March 2013, www.bankofengland.co.uk

¹⁷⁹²Joint Committee on the draft Financial Services Bill, First Report of Session 2010–12, *Draft Financial Services Bill*, HL Paper 236, HC 1447, para 49

to determine when and how such reviews would be conducted, and into which issues. There should be the presumption that ex-post reviews would be published, except where confidentiality needed to be maintained, in which case it might be desirable for either a redacted version to be published or for publication to be delayed.¹⁷⁹³

- Board members be authorised to see all of the papers considered by the MPC and FPC, to ensure that informed monitoring of processes and management was possible by the Board;¹⁷⁹⁴
- The new Board be responsible for avoiding groupthink within the Bank, and for reviewing committee processes;¹⁷⁹⁵
- the new Board be responsible for responding to requests to the Bank for factual information from Parliament and the Treasury;¹⁷⁹⁶
- the Bank strengthen the staff support for the new Board by a dedicated, high quality staff containing the skills and experience needed to fulfil its oversight functions;¹⁷⁹⁷
- the new Board's minutes be published to a timetable similar to that of the MPC, subject to any specific concerns of confidentiality which the Chairman of the Board should raise with the Chairman of the Treasury Committee;¹⁷⁹⁸
- the Chairman of the new Board have considerable experience of prudential or financial issues;¹⁷⁹⁹
- in addition to experience in running large organisations and financial institutions, members of the new Board have expertise in prudential policy;¹⁸⁰⁰
- the new Board be reduced from a membership of twelve to one of eight, comprising the Governor, the two Deputy Governors, an external Chairman, and four other external members;¹⁸⁰¹
- when the Board considered the Bank's annual budget, it be responsible for coming to an explicit view about both the level of, and changes to the allocation of, resources for all areas of activity, including the macro-prudential and monetary areas of work. It should provide public explanations of those decisions;¹⁸⁰²

1793 Treasury Committee, Twenty-first Report of Session 2010–12, *Accountability of the Bank of England*, HC 874, paras 81–82

1794 *Ibid.*, para 84

1795 *Ibid.*, para 102

1796 *Ibid.*, para 88

1797 *Ibid.*, para 71

1798 *Ibid.*, para 67

1799 *Ibid.*, para 52

1800 *Ibid.*, para 50

1801 *Ibid.*, para 54

1802 *Ibid.*, para 44

1090. These recommendations were subsequently supported by the Joint Committee on the draft Financial Services Bill, which concluded that:

The evidence we received in the course of our inquiry indicated that the House of Commons Treasury Committee was right to conclude that the governance structures within the Bank need considerable strengthening. [...] We support the idea that the Court should be replaced by a Supervisory Board with expert members some of whom should have experience in prudential policy. The new Supervisory Board would be empowered to scrutinise work of its sub-committees and conduct retrospective reviews of decisions taken by the FPC. The reforms in the draft Bill give the Bank significant new powers in macro- and micro-prudential policy. These powers must be paired with reforms to ensure that clear accountability processes are in place.¹⁸⁰³

1091. The response of the Government to the recommendations of these two Parliamentary Committees was half-hearted at best. The Financial Services Act 2012 created a new sub-committee of the Court, the so-called ‘Oversight Committee’, comprising the non-executive directors of the Bank. This will have the power to commission retrospective reviews of the Bank’s performance to be carried out either externally or internally. It, rather than the Court as a whole, will be responsible for monitoring the Bank’s response to, and implementation of, the recommendations of any review it commissions.¹⁸⁰⁴

1092. The Government rejected Parliament’s other proposals for governance of the Bank, including transforming the Court into a meaningful board of governance. It said that “In general, the Government considers that the governance of the Bank should primarily be a matter for the Bank itself”.¹⁸⁰⁵

1093. Although no statutory obligation is placed on the Court or the Oversight Committee to respond to reasonable requests for information from Parliament, that Committee’s examination of the new Governor, Dr Carney, suggested that he would have no objection to such a duty being placed in statute.¹⁸⁰⁶ Scrutiny by Parliament may be more difficult without such an obligation. **The Commission recommends that, in line with the recommendations of the Treasury Committee and the Joint Committee on the Financial Services Bill, the Bank of England be given a duty to respond to reasonable reports for information from Parliament.**

Financial Conduct Authority

1094. The Treasury Committee’s recommendations about the accountability of the FCA were that:

¹⁸⁰³Joint Committee on the draft Financial Services Bill, First Report of Session 2010–12, *Draft Financial Services Bill, HL Paper 236*, HC 1447, para 309

¹⁸⁰⁴Financial Services Act 2012, section 3

¹⁸⁰⁵HM Treasury, *A new approach to financial regulation: securing stability, protecting consumers*, Cm 8268, January 2012, para B2

¹⁸⁰⁶Oral Evidence taken before the Treasury Committee on 7 February 2013, HC (2012–13) 944, Qq 45-6

- That the board of the FCA publish full minutes of each meeting;
- That the legislation provide that the FCA Board be responsible for responding to requests for factual information and papers from Parliament;
- That the legislation provide that Parliament may request retrospective reviews of the FCA's work; and
- That the legislation provide that the Chief Executive of the FCA be subject to pre-appointment scrutiny by Parliament.¹⁸⁰⁷

Of these, the Government accepted only the first: the FCA has a duty under the Financial Services Act 2012 to publish the record of the meetings of its board.¹⁸⁰⁸

Retrospective regulatory reviews

1095. It is important that reviews are not only conducted in response to bank failures. This is particularly so because the PRA will not be operating a 'no failure' regime. Sir Mervyn King told the Commission:

I don't think we want to have reviews only when there are failures of banks because we don't regard the failure of a bank as in and of itself evidence of a regulatory failure. We are not going to operate a no-failure regime. So we need some reviews of where there aren't failures: "Has supervision been adequate?" and so on. So it is very important that we do not equate failure of a bank with a regulatory failure from the outset. That would be a serious mistake.¹⁸⁰⁹

Regulatory successes and 'near misses' will also be worthy of retrospective review.

1096. The absence of arrangements to ensure inquiries, whether internal or external, into past bank failures, such as those of Northern Rock, RBS and HBOS, was a serious weakness of the regulatory and governance arrangements. Many of those weaknesses remain in the new structure. They were or are being conducted by the FSA and were initially narrow in scope, concentrating largely on enforcement. In the case of RBS, the publication of any official report on the whole story of why the bank failed and what role the regulator played came only after intervention from Parliament: initially the FSA published just a 300 word press release at the end of its enforcement investigation. The FSA's report on RBS—published at the end of 2011¹⁸¹⁰—led to the FSA agreeing to produce a further report on the failure of HBOS, which is now being prepared. Andrew Bailey told the Commission:

I think the key point is that the model that was adopted, which, as you say, started with the Northern Rock investigation, was for the FSA to investigate itself. To me, that is a difficult model which is always likely to end up where it did, which is people

¹⁸⁰⁷Treasury Committee, Twenty-sixth Report of Session 2010–12, *Financial Conduct Authority*, HC 1574, para 80

¹⁸⁰⁸Financial Services Act 2012, Schedule 3

¹⁸⁰⁹Q 4575

¹⁸¹⁰FSA Board Report, *The failure of the Royal Bank of Scotland*, December 2011

then calling into question banking and the validity of it and it being, in a sense, reset, as it was particularly with RBS.¹⁸¹¹

1097. Sir Mervyn King told the Commission that, although the Oversight sub-committee of the Bank would authorise and commission inquiries, they would be conducted by an external party. Sir Mervyn King explained the reasons for this:

[...] during the creation of the PRA we spent a lot of time talking to supervisors, both former supervisors in the UK and elsewhere, about the right model for supervision. One thing that struck me very forcefully talking to these people is that only one review of a bank failure episode commanded confidence among those involved. That was the Bingham inquiry after the BCCI failure. Why was that? Because Lord Justice Bingham was regarded as a person of unimpeachable integrity and was completely objective. He had no agenda of his own, no side, no particular issues to pursue, and he gave everyone a fair hearing. In my view, that is vital if you are going to have confidence in the process of holding an inquiry. You cannot have an institution like the PRA investigating itself, because one person in that institution will be asked to sign a document that is a report on the behaviour of other people in the same organisation. No one is going to believe that that is a fair process, and in large part, it will not be. It is very important to have these external inquiries, and that is exactly what the Bank will do.¹⁸¹²

He also believed that because the board of the PRA would be making major regulatory decisions, it would not be appropriate for the PRA board to undertake reviews, as the FSA had done in the past.¹⁸¹³

1098. When things go wrong in banks it is possible for both the bank itself—assuming it has survived—and the regulator to investigate what went wrong. It is good corporate governance practice for both of them to do so, in order that they learn from events. But only Parliament can hold the regulator itself to account for its actions. In the case of the failures of RBS and HBOS, the Treasury Committee has used the innovation of specialist advisers working inside the regulator in order to obtain an assurance that the regulator's report was a fair and balanced account.

1099. There remain problems with any investigation undertaken by or at the behest of regulators themselves or individual companies. The Swiss Government appointed Dr Tobias Straumann, an independent academic, to undertake a critical examination of the failures of UBS in investment banking and cross-border wealth management, and the resulting report, while addressed to the UBS Board, was arguably more hard-hitting than the reports on either the failure of RBS or the Salz Review.

1100. In April 2013, the FCA released details of how it will conduct investigations into regulator failures. This report noted that the FCA Board would oversee any investigation process and that the precise nature of this oversight (for example whether it is necessary to

1811Q 4574

1812Q 4575

1813Q 4577

set up a sub-committee of the Board for the purpose) will depend on the circumstances of each case. The report notes that:

Independence will be built into the process of conducting an investigation and producing a report. If necessary, parts of the investigation may be outsourced. Where investigations are not outsourced, they will be undertaken by (unconflicted) staff not part of the original events, and managed by areas not part of the frontline. Independent reviewers may be part of the process if necessary.¹⁸¹⁴

1101. The Financial Services Act 2012 creates a duty for the PRA to investigate possible regulatory failures where either public expenditure has been incurred or events have risked a significant adverse effect on the safety or soundness of a PRA-authorized firm.¹⁸¹⁵ The Act also allows the Treasury to set up an independent inquiry into events with serious, or potentially serious, implications for financial stability or for consumers arising because of a failure in the system established by FSMA.¹⁸¹⁶

1102. The Financial Services Act 2012 gives the PRA a veto over the FCA where, in the opinion of the PRA, an action by the FCA may either threaten the stability of the UK financial system or result in the failure of a PRA-authorized person in a way that would adversely affect the UK financial system. The Treasury Committee was unconvinced of the Government's case for the veto, and believed that as a tool for maintaining financial stability, it ought to lie with the FPC rather than the PRA. It also said that any use of the veto would be an appropriate candidate for retrospective review.¹⁸¹⁷

1103. Although many institutions can examine what goes wrong in banks, only Parliament can hold regulators to account. In the past, regulators themselves have undertaken investigations into bank failures which, where regulatory failure may also be at issue, is unsatisfactory. The Treasury Committee used specialist advisers to provide an assurance that the FSA's report on the collapse of RBS—which included an examination of the FSA's own role—was fair and balanced. This mechanism also avoided the risk that no report might be produced at all because of concerns that the regulator might be conflicted. The report on RBS that was eventually produced has proved to be of value. In any equivalent case in the future, the Commission recommends that regulators consider the case for an investigation led by an independent person appointed with the approval of Parliament.

Conclusions on regulatory accountability

1104. The new, highly complex, regulatory structure represents a further delegation by Parliament of decision-making powers that formerly lay with Ministers. Many of these powers could be of great significance and their use will trigger public debate and

¹⁸¹⁴FCA, *How the Financial Conduct Authority will investigate and report on regulatory failure*, 18 April 2013, para 710, www.fca.org.uk

¹⁸¹⁵Financial Services Act 2012, sections 74-76

¹⁸¹⁶*Ibid.*, sections 68-72

¹⁸¹⁷Treasury Committee, Twenty-sixth Report of Session 2010–12, *Financial Conduct Authority*, HC 1574, paras 95 and 97; Treasury Committee, First Report of Session 2012–13, *Financial Services Bill*, HC 161, para 69

generate controversy. Ministers taking such decisions are accountable to Parliament and to the electorate, but the new regulatory structure needs accompanying accountability mechanisms to ensure that Parliament, and through Parliament the public, have the explanations to which they are entitled.

1105. Strong accountability mechanisms are also in the interests of the new regulators themselves. Without the authority and legitimacy that comes from being held properly and publicly to account, they are likely to be less confident in taking difficult and possibly unpopular decisions.

1106. The accountability arrangements of the new structures are more complex than those of the previous regulatory regime. The PRA is a subsidiary of the Bank, and the FPC is a sub-committee of the Court of the Bank. Since the Government's proposals for regulatory reform first emerged in 2010, the future accountability to Parliament of the new bodies created by that reform appears to have been treated by those responsible as an afterthought. Progress has been very slow, and piecemeal changes as the Bill that became the Financial Services Act 2012 went through Parliament have provided only partial solutions. It took constant pressure from Parliament to prompt the Government and the Bank of England to concede even the unsatisfactory half-way house that is the Oversight sub-committee. Retrospective reviews of the performance of the Bank of England should be of value. However, as the power of review is in the hands of a sub-committee of the Court, rather than the Court itself, the creation of this body will further complicate the already complex lines of accountability of the Bank, not least to Parliament. At worst, the new Oversight sub-committee could end up owing more to form than to substance. The subordination of the Oversight sub-committee to the Court as a whole means that Parliament will need to rely, ultimately, on the Court of the Bank—which includes the Bank's most senior executives—to fulfil the Bank's duty of accountability to the House. This is a serious weakness of the new legislation.

1107. Accountability for the new regulatory structure, and in particular the central and very powerful Bank of England, requires further improvements in corporate governance. In the case of the Bank, the Commission considers it essential for the Court to be reformed as far as possible into a meaningful board—along the lines recommended in 2011 by both the Joint Committee on the Financial Services Bill and the Treasury Committee. The Commission recommends accordingly.

1108. One further change is also required, arising from the fact that the PRA is embedded within the Bank of England. The chief executive of the PRA, who is the Deputy Governor for Prudential Regulation, is accountable for the performance of the PRA, but the board of the PRA is chaired by the Governor of the Bank, the chief executive's immediate superior within the Bank. This risks the Governor involving himself in the detailed decisions of the PRA and so undermining the accountability, and possibly the authority, of the PRA's chief executive. The Commission recommends that the senior independent Board member chair the PRA. The Governor should remain a member of the board of the PRA.

The new responsibilities

1109. In this Report we have made a number of recommendations for new regulatory responsibilities, relating to:

- Re-shaping the remuneration arrangements within banks;
- Preparing and promulgating a Code for banking staff;
- Establishing and operating a Senior Accountable Persons Regime;
- Establishing a new registration regime for staff of banks who make decisions which bear risk but are not subject to the Senior Accountable Persons Regime;
- Establishing a new register of bank staff within the Senior Accountable Persons Regime or in respect of whom relevant information is held in consequence of the licensing obligations.

1110. **In making our recommendations we have referred in general terms to the regulators rather than specifying in each case whether the functions and responsibilities should fall to the PRA or the FCA or both in cooperation. Nonetheless, it is essential that lead responsibility be clarified in each case. The Commission recommends that the FCA, the PRA and the Government prepare, for publication alongside the Government response to this Report, a proposed allocation of lead responsibility for each of the recommendations for regulatory action, directly or in consequence of new legislation, contained in this Report.**

Physician, heal thyself

1111. **Our recommendations on regulatory structures and accountability are designed to create a framework to ensure that regulators are robustly independent and focus on using their judgement to achieve the objectives set for them by Parliament. Regulators' judgements must ultimately be subject to sufficient democratic accountability to ensure that a full explanation is given for their decisions.**

1112. **A lesson in our First Report, and this one, is that politicians can be tempted to heed the blandishments of bankers and succumb to lobbying. This makes the regulators' job all but impossible. No-one can tell whether or when these risks may emerge. But the danger remains.**

1113. **The Governor of the Bank of England is, by virtue of his responsibilities and independence, uniquely well-placed to sound the alarm if bank lobbying of Government is becoming a concern. The Commission recommends that it be a specific personal responsibility of the Governor to warn Parliament, or the public in such circumstances.**

Warnings from history

1114. As we said in Chapter 3, the regulatory authorities have repeatedly failed to learn the lessons of history; too many times in the past, no-one in authority has been prepared to challenge the economic orthodoxy and warn of the consequences of market excesses. The creation of the FPC, with its responsibility for monitoring and acting upon systemic risks with the purpose of promoting financial stability, has addressed this problem to some extent. It is designed to have the independence and authority to use its potentially significant powers of direction and recommendation. However, there have been recent developments that give rise to reservations about the FPC's independence and its ability to act in a counter-cyclical manner when necessary:

- Not all external members of the interim FPC were reappointed to the permanent body. This gave rise to public discussion as to whether their service was being dispensed with for expressing opposition to aspects of Government policy;
- The FPC will not be given the power of direction to vary over time the leverage ratio before 2018, and it will be subject to review in 2017 to assess progress with international standards—the Government is therefore reserving the right to delay transfer further;¹⁸¹⁸
- The Chancellor wrote to the Governor on 30 April 2013 setting out: the economic policy of the Government for the FPC; matters that the Financial Policy Committee should regard as relevant to the Bank's financial stability objective; the responsibility of the Committee in relation to the achievement of that objective; and a series of recommendations to the FPC as to its responsibility in relation to support for the Government's economic policy, and matters to which the Committee should have regard in exercising its functions.¹⁸¹⁹

1115. We see merit in bringing further external views to the FPC and in reinforcing its focus on avoiding the mistakes of the past. **The Commission recommends that an additional external member be appointed to the FPC, with particular responsibility for taking a historical view of financial stability and systemic risk, and drawing the attention of FPC colleagues, and the wider public through speeches and articles, to historical and international parallels to contemporary concerns.**

¹⁸¹⁸HM Treasury, *The Financial Services Bill: the Financial Policy Committee's macro-prudential tools*, September 2012, para 4.31

¹⁸¹⁹Letter from the Chancellor of the Exchequer to the Governor of the Bank of England, 30 April 2013, www.hm-treasury.gov.uk

10 Sanctions and enforcement

Introduction

1116. In previous chapters we have examined various ways in which the standards and culture of banks and individuals working in banks can be changed—through changes to the competitive environment (Chapter 5), through radical changes to the incentives offered by remuneration (Chapter 8), through a new framework for individual responsibility (Chapter 6), through changes to bank governance and culture (Chapter 7) and through changes to the supervisory and regulatory approach (Chapter 9). Our proposals in those chapters are predominantly preventative in their aims—to reduce the chances of things going wrong. However, it is essential that preventative measures are backed up by suitable sanctions when things do nevertheless go wrong. It is also important to consider the role which effective sanctions and powers of enforcement can play as a deterrent in changing behaviour. Box 21 sets out how the recommendations from these chapters will together result in significant changes to individuals' incentives and the consequences for standards.

Box 21: The effects of reforms on individuals

The Commission's reforms are intended to create a banking sector where failures in banking standards are less likely to arise, where there are stronger mechanisms for correcting failures when they start to escalate, and where, when serious failures do nevertheless occur, there are robust tools for holding those responsible to account and imposing appropriate penalties. The prospect of such penalties would in turn feed back into better incentives for bankers to behave correctly in the first place. This box sets out some illustrations of the practical differences which some of the proposed reforms might make.

Senior Persons Regime

Senior managers of banks will no longer be able to hide behind an accountability firewall, where they are too distant from the consequences of their responsibilities to be held directly accountable when things go wrong. A future investigation into a scandal such as Libor manipulation should not result in the trail going cold half-way up an organisation, but should be capable of leading directly to the senior executive whose lack of oversight permitted it to happen. More clarity over responsibilities should also help avert future disasters comparable to PPI mis-selling, where shared responsibilities and decisions by committee meant that nobody felt responsible for checking that the products were appropriate for customers and appropriately sold to them.

The Senior Persons Regime will clearly attribute responsibilities to individuals. Senior Persons will know that they can be held accountable and subjected to enforcement measures if they fail to uphold those responsibilities. The regulators will have two enhanced enforcement tools which can be applied to those individuals within the Senior Persons Regime.

The proposal to reverse the burden of proof for imposing regulatory penalties on Senior Persons in certain circumstances would make sure that those who should have prevented serious prudential and conduct failures would no longer be able to walk away simply because of the difficulty of proving individual culpability in the context of complex organisations. Once successful enforcement action had been taken against a bank, such as for the failures relating to Libor manipulation or the near-failures of RBS and HBOS, the Senior Persons with responsibilities for the areas that failed would have to show how they upheld those responsibilities and acted properly in trying to prevent the failure.

The introduction of a criminal offence for reckless mismanagement of a bank would provide a new range of sanctions, which could include imprisonment. It would provide stronger deterrence for individuals in the Senior Persons Regime. Criminal prosecutions would only be used in cases resulting in the most serious public harm and with the most serious misbehaviour, where civil penalties alone would not suffice.

Licensing

The Licensing regime will cover a broader range of individuals than those who are currently within the Approved Persons Regime. For example, all the traders and rate submitters who were involved in Libor manipulation, as well as their managers, would have been within scope of the new Licensing regime as their actions could—and did—cause serious harm to the bank. Many of these individuals were not covered by the APER. The APER has since been extended to cover rate submitters, but moving to Licensing avoids reliance on such a reactive approach and makes it less likely that the next scandal will emerge in an area found again to be outside scope of the framework for enforcement.

The Licensing regime requires individuals to sign up to and abide by the new Banking Standards Rules. The Rules should be much clearer and more accessible than the Principles for Approved Persons, and banks will have a duty to ensure Licensed staff fully understand how the Rules apply to their work. As a result of the Licensing Regime, no bankers who can cause serious harm to the bank or to customers, such as those involved in areas such as the submission of Libor rates or selling interest rate swaps, will be able to claim ignorance of what is and is not acceptable behaviour.

The Licensing regime allows the regulators to use their existing range of enforcement tools against anybody within its scope when the Rules are breached. Available sanctions include suspension, prohibition and unlimited fines.

Reforms to remuneration

The Commission's proposals for a new Remuneration Code would encourage a much higher degree of deferred compensation, and for a wider range of employees. It would ensure that more compensation would be lost to employees if it emerged that they contributed to failures in banking standards or were awarded compensation on the basis of illusory successes. For example, this could cover executives who presided over weak control

frameworks which led to scandals such as Libor or money laundering. Likewise, it could cover individual bankers who engaged in excessively risky lending which gave high returns for a few years—resulting in high bonuses—then caused a large loss when the loans went bad. Aligning the length and amount of deferral more closely with the period over which risks in banking become visible will help reduce the chances of bankers playing “heads I win, tails you lose” with the bank’s money. In addition, where a bank received taxpayer support, the authorities would have powers to render void all deferred compensation, entitlements arising from change of control and unvested pension rights for Senior Persons and other licensed staff, ensuring that the taxpayer would not pick up the bill for paying those who drove the bank to failure to head off into comfortable retirement.

Enforcement against banks

The current approach

1117. When there are significant failings within a bank, one regulatory response has been enforcement action against the bank in question. In relation to one of the largest prudential failings of recent years, the FSA issued an enforcement notice against HBOS in 2012 for serious misconduct during the period 2006-2008, which contributed to its failure. The FSA enforcement notice stated:

The severity of Bank of Scotland’s failings during this time would, under normal circumstances, be likely to warrant a very substantial financial penalty. However, because public funds have already been called on to address the consequences of Bank of Scotland’s misconduct, levying a penalty on the enlarged Group means the taxpayer would effectively pay twice for the same actions committed by the firm. Therefore, to reflect these exceptional circumstances, the FSA has not levied a fine against Bank of Scotland but has issued a public censure to ensure details of the firm’s misconduct can be viewed by all and act as a lesson in risk management failings.¹⁸²⁰

The FSA has not taken enforcement action against the firm in relation to most of the other notable prudential failures in recent years, including RBS, Northern Rock, and Bradford and Bingley, even though the logic of the HBOS enforcement action could be held to have applied in those cases.

1118. The most notable recent enforcement actions against banks were those in relation to LIBOR manipulation. This Commission was established in the aftermath of the first fine announced in late June 2012 against Barclays. Since then, the FSA has imposed two even larger fines on UBS and RBS in relation to the same issue. There have been a number of less high profile actions, for example a £1.5m fine on Santander in 2012 for failing to clarify Financial Services Compensation Scheme cover on structured products,¹⁸²¹ a £4.3m fine on

¹⁸²⁰“FSA publishes censure against Bank of Scotland plc in respect of failings within its Corporate Division between January 2006 and December 2008”, FSA press note FSA/PN/024/2012, 9 March 2012

¹⁸²¹“Santander fined £1.5 million for failing to clarify FSCS cover on structured products”, FSA press release FSA/PN/017/2012, 20 February 2012

Lloyds Banking Group in 2013 for delayed PPI redress payments,¹⁸²² and a £9.45m fine on UBS in 2013 for mis-selling an investment fund.¹⁸²³

1119. In relation to one of the biggest conduct scandals of recent years—PPI mis-selling—formal enforcement action against the largest perpetrators has been limited. Clive Briault, a former Managing Director at the FSA, told us that, following a thematic review in 2006, five firms were referred to enforcement, one of which was Lloyds TSB:

the FSA’s enforcement division then spent the best part of two years in a much more extensive investigation of the sales practices of Lloyds TSB in the area of PPI. [...] at the end of that, although the enforcement division found that there were a number of sales practices which were not necessarily of the highest standard, nevertheless, overall, there was not a case to bring enforcement action against that particular firm.¹⁸²⁴

He noted that enforcement action was pursued against the other four firms investigated in 2006, but conceded that these were:

much, much smaller institutions, where it would have been much easier for the enforcement division to review the relevant files and take a view whether the deficiencies in sales practices were such as to merit enforcement action.¹⁸²⁵

The largest penalty imposed on a bank for mis-selling PPI was the £7m fine on Alliance and Leicester in 2008, a tiny proportion of the revenue gained from selling the product.

1120. Far more significant as a penalty, in the case of PPI, has been the cost of providing customer redress, for which Natalie Ceeney told us banks have already provisioned over £12bn.¹⁸²⁶ Such compensation payments are likely to exceed the level of fines that could have been sustained had the FSA pursued enforcement action. It is notable that in the case of interest rate swap mis-selling, the response to-date appears to be focused on redress. No enforcement investigations have yet been announced, although Martin Wheatley has been reported as saying that enforcement would not be ruled out.¹⁸²⁷

1121. In order to initiate enforcement proceedings, regulators consider that they must have a basis for investigating. Sir Hector Sants told us that “you need a trigger”, noting that in cases such as LIBOR manipulation it was unrealistic to expect the supervisor to spot the wrongdoing before it became apparent to the firm itself:

When we are talking about misbehaviour by individuals in very large institutions, it is difficult to envisage that you could ever construct a regulator that would be able to discover that misconduct if it was not visible to the firm. [...] It would take a regulator

1822 “Lloyds Banking group fined £4.3 million for delayed PPI redress payments”, FSA press release FSA/PN/017/2013, 19 February 2013

1823UBS, FSA Final Notice, 8 February 2013

1824JQ 160

1825JQ 163

1826KQ 771

1827 “Banks face £10bn bill over swaps mis-selling scandal”, *The Telegraph*, 1 February 2013, www.telegraph.co.uk

of massive resource to find these sorts of issues. The number of instances of them is very small. There are millions of e-mails and documents involved, so the idea that a conduct regulator will proactively spot these issues on its own is a false hope [...]without a trigger of information it is relatively unlikely that, even if a supervisor had 40 people rather than four, it would make a huge difference.¹⁸²⁸

1122. Sir Hector Sants and Tracey McDermott argued that the FSA had responded swiftly and decisively once evidence of LIBOR manipulation emerged,¹⁸²⁹ but Ms McDermott also identified some indicators that the regulators could employ more effectively to assist in identifying potential problems in future:

one of the things that drives bad behaviour is that people think it is a way of making profit. If you look at PPI or if you look at LIBOR, it is driven by that. As a conduct regulator, we need to be much clearer about where the firm's money is actually being made, and then we need to be looking very clearly at whether there is adequate control around that.

The other thing that I would say is a series of red flags—it was demonstrated by UBS, but also by some other firms—is a series of serious failures in different bits of the business. Some of them may not individually be massively significant, but what does that say about the culture if people in quite disparate parts of the organisation can basically get around the rules?¹⁸³⁰

The level of fines for banks

1123. While a completed enforcement action might have reputational effects on the bank concerned, the most direct effect can be in the form of a fine. Former regulators indicated that the level of fines historically had done little to dent bank balance sheets. Clive Briault noted, in the context of PPI mis-selling, that, “if you compare the level of the fine against the big profitability of the business, you could choose to regard it as a cost of doing business”.¹⁸³¹ This view was echoed by another form member of FSA staff, Thomas Huertas:

If the penalty were only monetary and only on the firm, the great danger is that the firm will simply see this as a cost of doing business. There is no more insidious element from a supervisory standpoint than trying to deal with a firm when it has a view that bad behaviour is something that can simply be priced in.¹⁸³²

Sir Hector Sants acknowledged that:

the deterrence element of the historical approach of the FSA was not sufficient for this type of wilful wrongdoing. I think we do need to be very clear about the distinctions between different types of regulatory action, but I'm talking about the

1828Qq 2245, 2252

1829Q 2306

1830Q 2317

1831JQ 191

1832EQ 57

fact that people ought to believe that if they are wilfully engaged in conduct wrongdoing, they have a reasonable chance of being caught, and that if they are caught, the sanction is significant, both to the firm and to the individual.¹⁸³³

1124. The three FSA fines relating to LIBOR manipulation, of £59.5 million on Barclays, £160 million on UBS and £87.5 million on RBS, were the largest that the FSA has ever imposed. The FSA pointed out that the Barclays penalty, the lowest of these, was “approximately double the previous highest penalty that the FSA had imposed on a firm”.¹⁸³⁴ The fines imposed on these three firms by the US authorities were significantly larger, at \$360 million, \$1.2 billion and \$475 million respectively. The US authorities have recently imposed a series of other large fines on UK banks, including a \$1.9 billion fine on HSBC for inadequate compliance with money-laundering and sanctions rules,¹⁸³⁵ and a total of \$667m of fines on Standard Chartered in relation to inadequate compliance with sanctions rules.¹⁸³⁶

1125. The FSA explained that the legal basis for imposing fines was different in the two countries. The UK regime requires the fine to be determined in relation to a number of factors in the round, including consideration of penalties in comparable cases. In contrast, the CFTC in the US imposes penalties by applying a tariff to each violation, although the CFTC orders did not disclose the basis for its calculations of LIBOR fines.¹⁸³⁷

1126. Sir Hector Sants noted that the FSA has already taken steps to allow larger fines to be imposed on firms:

it has been a consistent approach of mine, during my time at the FSA, to seek to change the FSA’s regime so that its fines would increase in size. Those changes were brought in [...] so any offences that occur after 2010 are likely to lead to much higher fines.¹⁸³⁸

The FSA confirmed that the policy change with effect from March 2010 had led to a doubling or trebling of penalties compared with the previous tariffs.¹⁸³⁹ They also noted that, because most of the misconduct relating to LIBOR manipulation had taken place before 2010, the penalties were calculated on the basis of the old policy.¹⁸⁴⁰

1127. The FSA’s penalty policy now allows for the level of fines to be adjusted to take account of a number of factors. These include aggravating or mitigating factors such as the firm’s level of cooperation, whether the case is brought to the attention of the regulators quickly, and whether the misconduct was the result of a breach of previous warnings or

1833Q 2308

1834Ev 1025

1835 “HSBC Announces Settlements with Authorities”, HSBC announcement, 11 December 2012

1836 “Standard Chartered pays \$327m to settle Iran fine”, *The Telegraph*, 10 December 2012

1837Ev 1052

1838Q 2308

1839Ev 1052

1840*ibid.*

requirements.¹⁸⁴¹ For example, the FSA stated that they took consideration of the co-operative approach by Barclays in the investigation into fixing of LIBOR when determining the fine.¹⁸⁴² A fine can be increased if the resulting fine would otherwise provide insufficient deterrence,¹⁸⁴³ and a discount of up to 30 per cent is available for early settlement, intended to reduce the probability of protracted and costly litigation.¹⁸⁴⁴

1128. Banks have moved towards linking fines more strongly to employee remuneration, so that the cost of fines is not simply passed on to shareholders but also falls on employees, thereby creating incentives for good behaviour.¹⁸⁴⁵ However, the tendency to deduct fines predominantly from the current year's bonus pool reduces transparency and undermines the effectiveness of the policy. Sir Philip Hampton, when questioned in evidence, was unable to state clearly how RBS would prove that its bonus pool would actually be reduced as a result of the Libor fine, given that the initial size of the bonus pool had yet to be determined:

Mark Garnier: How do we know that you are not just going to increase the bonus pool sufficiently to be able then to reduce it by the fine, getting around the vexing problem that way?

Sir Philip Hampton: As we said earlier, we have to be very clear and public—to this Commission and elsewhere—that we have exercised clawback properly.

Mark Garnier: Is it clear when something doesn't exist yet—this year's bonus pool?

Sir Philip Hampton: We will have to support the argument that we have committed to clawing back the US elements of this fine.¹⁸⁴⁶

Sir Philip Hampton admitted that the pool of unvested bonuses from previous years would more than cover the size of the fine, but was unable to confirm how much was coming from this pool compared to the current year's bonus pool.¹⁸⁴⁷

Conclusions

1129. 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

1841PRA and FSA Handbook, DEPP 6.5A.3, www.fsahandbook.info

1842Barclays, FSA final notice, 27 June 2012, para 208

1843PRA and FSA Handbook, DEPP 6.5A.4, www.fsahandbook.info

1844PRA and FSA Handbook, DEPP 6.5A.5, www.fsahandbook.info

1845“RBS reaches LIBOR settlements” RBS statement, 6 February 2013, www.rbs.co.uk

1846Qq 4198-4199

1847Qq 4200-4207

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.

1130. 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.

1131. 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.

1132. 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.

1133. 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”.¹⁸⁴⁸ 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

¹⁸⁴⁸Treasury Committee, Second Report of Session 2012–13, *Fixing LIBOR: some preliminary findings*, HC 481, para 16

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 stifle the free flow of information.

1134. Enforcement action against individuals normally only takes place after completion of enforcement action against the firm, in part because the risks of delay with individual enforcement are greater.¹⁸⁴⁹ **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.**

Enforcement against individuals

The need

1135. As we noted in Chapter 3, one of the most striking features of the recent years has been that the failures of the banking sector—including both the prudential failures which led to the near collapse of some major banks and required massive taxpayer bailouts, and the conduct failures which led to large-scale mis-selling—did not lead to action against individuals on anything approaching a seemingly commensurate scale. Actions against individuals are still outstanding in relation to LIBOR, but the evidence received made clear that these actions would not be against the most senior individuals within the banks subject to enforcement action.

1136. Enforcement action against Approved Persons at senior levels is as rare as hens' teeth. As Andy Haldane put it: "the sanctions are never imposed. Everyone is 'fit and proper' all of the time".¹⁸⁵⁰ Exceptions prove this rule. Peter Cummings, the former head of the Bank of Scotland's corporate division, has been fined £500,000 and given a lifetime ban from the industry.¹⁸⁵¹ The FSA intended to pursue an industry ban on Johnny Cameron, but ended their investigation in 2010 when he voluntarily agreed not to work in the industry again. In neither case did enforcement action intrude into the world of those at the very top of these failed banks. The Chairmen and successive Chief Executives of HBOS have so far escaped any public enforcement action. The same can be said in the context of the Chairman and Chief Executive of RBS. Nor has the most significant conduct failure of recent years with the largest impact on bank customers—the systematic mis-selling of PPI over a long period—led to any enforcement action against senior individuals in banks, as we noted earlier.¹⁸⁵²

1849Q 2286

1850Q 172

1851Fourth Report, para 129

1852See Paragraph 198.

1137. The apparent failure of the sanctions regime in the context of the multiple failures of standards in banking industry matters for several reasons. One reason was set out by Lord Turner in his Foreword to the FSA's Report on the failure of RBS:

Banks are different because excessive risk-taking by banks (for instance through an aggressive acquisition) can result in bank failure, taxpayer losses, and wider economic harm. Their failure is of public concern, not just a concern for shareholders.

There is therefore a strong public interest in ensuring that bank executives and Boards strike a different balance between risk and return than is acceptable in non-bank companies. This argues for ensuring that bank executives face different personal risk return trade-offs than those which apply in non-banks.¹⁸⁵³

1138. Second, as we noted in the context of the collapse of HBOS, the absence of fitting sanctions for those most responsible meant that such sanctions could not serve as a suitable deterrent for behaviour contributing to the next crisis.¹⁸⁵⁴ Andy Haldane emphasised the importance of sanctions in encouraging those at the most senior levels to assume greater personal responsibility:

Not knowing cannot be a legitimate excuse. If it was made clear that, whatever the product or whatever the asset, if it is not doing what it is meant to be doing, the sanction will be meted out at the highest level of the firm, and that those incentives would run down the core of the firm from the top, that would help. I think that if the CEO, or the chief risk officer or the chief operating officer, knew that their job was on the line, their behaviours would then rub off all the way down the organisation. You would find fewer of these products being sold in the first place; you would find fewer of these assets finding their way on to the balance sheet.¹⁸⁵⁵

1139. Antony Townsend, Chief Executive of the Solicitors Regulatory Authority, suggested that a credible sanctions regime was an essential component in creating a professional ethos:

The risk of public identification and, of course, ultimately, loss of livelihood, is a very powerful sanction. There is an element of regulation being an act of faith, but the research we have [...] suggests that those we are regulating see the existence of the sanctions regime as an important part of being in a regulated profession, almost driving professional pride.¹⁸⁵⁶

1140. There is also a simple utilitarian reason why a sanctions regime that bites upon more individuals matters. Many of those who served at senior levels in banks that failed during the financial crisis have gone on to work elsewhere in the financial services sector. For example, many members of the RBS board and executive committee went on to work for

1853FSA Board Report, *The Failure of the Royal Bank of Scotland*, December 2011, p 9

1854Fourth Report, para 136

1855Q 172

1856Q1841

other banks or financial services firms.¹⁸⁵⁷ Some of the facts released about LIBOR fixing in just three banks indicates that certain key individuals implicated in wrong-doing moved on from bank to bank. If it were to be demonstrated that such individuals bear responsibility for failings in standards in one bank, and they are prevented from carrying in activities in the banking sector, then the further damage is prevented as a consequence.

1141. An effective sanctions regime is also essential for the restoration of public trust in banking. The public distaste, and at times even revulsion, at the failures of bank standards in recent years has been magnified by outrage that those who were rewarded so well when things seemed to be going well can walk away without any realistic likelihood of enforcement action or the imposition of sanctions, having benefited from very high levels of remuneration and with massive pension entitlements

The sanctions currently available

1142. The regulators have several sanctions available to them in relation to those individuals—around 10 per cent of bank staff—who are subject to the Approved Persons Regime and thus required to act in accordance with the Statement of Principles—concepts we explained in Chapter 6. In respect of such people the regulators can, for example:

- publish a statement of the individual’s misconduct (i.e. a public censure);
- impose, for such period as the regulators consider appropriate, such limitation or other restrictions in relation to the performance by the individual of any function to which the approval under the Approved Persons Regime relates;
- suspend, for such period as the regulators consider appropriate, any approval of the performance by the individual of any function to which the approval under the Approved Persons Regime relates;
- withdraw an individual’s approval;
- impose a financial penalty on an individual of such an amount as the regulators consider appropriate.¹⁸⁵⁸

These are civil penalties which can be imposed directly by the regulator (subject to independent decision-making through structures we consider further in the next chapter) without reference to the courts. However, an individual who does not accept a finding or a proposed penalty may appeal to the Upper Tribunal, effectively a court of law.¹⁸⁵⁹

1143. For all bank staff, including the 90-odd per cent who operate outside the Approved Persons Regime, the regulators can apply their power to prohibit such an individual from working in the financial services industry, although it is harder to justify exercise of this

¹⁸⁵⁷“Where are they now: What became of the 18 Royal Bank of Scotland directors who oversaw its demise?”, *Scotland on Sunday*, 11 December 2011

¹⁸⁵⁸Ev 1474

¹⁸⁵⁹HM Courts and Tribunals Service, Tax and Chancery (Upper Tribunal) guidance, www.justice.gov.uk

severe power (in relation to both approved and non-Approved Persons) because an extended set of criteria needs to be met.¹⁸⁶⁰

1144. Some witnesses argued that the range of sanctions available, at least in relation to those within the Approved Persons Regime, was adequate. Jon Pain, a former managing director of supervision at the FSA, characterised the sanctions as “pretty severe”, including as they did a ban from the industry.¹⁸⁶¹ Professor Julia Black also remarked:

the FSA has a decent range of sanctions. It can fine and it can ban somebody from working in the industry, which probably has a much bigger impact than a fine because it has a long-term impact on the ability to earn a living in a very well-remunerated business.¹⁸⁶²

Evidential standards and individual culpability

1145. The severity of these sanctions in principle has, of course, been circumscribed in practice by the rarity of their being applied in the context of the banking sector. As Tracey McDermott put it, “even the regulatory sanctions at the moment we have not been able to enforce”.¹⁸⁶³ She attributed this inability first and foremost to the evidential standards required:

the test for taking enforcement action is that we have to be able to establish personal culpability on the part of the individual, which means falling below the standard of reasonableness for someone in their position. The way in which our guidance is drafted makes it very clear that we will not hold somebody to account simply because there is a failure on their watch, particularly if they have properly delegated and so on.¹⁸⁶⁴

Under this guidance, an Approved Person will only be held to be in breach of a Statement of Principle where he is personally culpable. Personal culpability arises where an Approved Person’s conduct was deliberate or where the Approved Person’s standard was below that which would be reasonable in all the circumstances. With a director and senior manager, the following factors are to be taken into account:

- whether he exercised reasonable care when considering the information available to him;
- whether he reached a reasonable conclusion which he acted on;
- the nature, scale and complexity of the firm’s business;
- his role and responsibility; and

¹⁸⁶⁰PRA and FSA Handbook, *FSA Handbook: Enforcement Guide*, Chapter 9.9, www.fsahandbook.info

¹⁸⁶¹JQ 218

¹⁸⁶²Q 2626

¹⁸⁶³Q 3034

¹⁸⁶⁴Q 2992

- the knowledge he had, or should have had, of any regulatory concerns.¹⁸⁶⁵

1146. As set out above, the basis for a judgement on a decision by an individual director is not whether that decision can be shown to be wrong with the benefit of hindsight, but whether at the time he failed to reach a reasonable conclusion. Of the two cases that the FSA has brought against senior bank executives in recent years, only one went to the Upper Tribunal, and that decision was overturned because this standard of proof had not been met. The Tribunal decision concluded:

The FSA has not satisfied us [...] from the evidence as a whole that Mr Pottage's standard of conduct was 'below that which would be reasonable in all the circumstances' [...] In particular we are not satisfied that [the alleged failure] was beyond the bounds of reasonableness. Put positively, we think that the actions that Mr Pottage in fact took prior to July 2007 to deal with the operational and compliance issues as they arose were reasonable steps.¹⁸⁶⁶

1147. The direct challenges from the evidential standard can be compounded by the complexity of decision-making structures in banks. Decisions might be taken by committees, thus making it harder to trace individual responsibility. Sometimes the attribution of responsibility at senior levels has been unclear. Professor Julia Black said:

For the FSA to bring a case under [the Approved Persons' Regime] they have to be able to pinpoint whether you were the person who made this particular decision and were responsible for this particular line of business over probably quite a period of time.¹⁸⁶⁷

These may well have been important factors in explaining the absence of enforcement action against senior managers in cases such as PPI mis-selling and LIBOR manipulation. Despite the clear failures in senior leadership collectively, identifying individual responsibility and culpability is likely to have been more difficult.

1148. Tracey McDermott emphasised the particular difficulties of enforcement action against individuals in large and complex institutions in explaining why it appeared that the US authorities were successful in taking action against individuals—the FDIC told us that they had brought 742 cases against individuals in 2012¹⁸⁶⁸—while the UK authorities were less so:

The big distinction between the FDIC's actions and ours is that the FDIC's constituents are largely smaller institutions [...] They are focused on the smaller institutions for which, as I have already said, it is actually much easier to find evidence. That is a practical matter, because the chains of command are shorter. If you look at the larger US institutions—the ones that failed, such as Lehman's, or those that were bailed out—there has not been any enforcement action that I am

¹⁸⁶⁵FSA, APER 3.3 Factors relating to Statements of Principle 5 to 7, www.fshandbook.info

¹⁸⁶⁶Upper Tribunal (Tax and Chancery Chamber), *Decision on John Pottage and the Financial Services Authority*, FS/2010/33, 20 April 2012, www.tribunals.gov.uk

¹⁸⁶⁷Q 2626

aware of, and I have checked this with the Americans, against the senior management of those institutions.¹⁸⁶⁹

The approach to enforcement

1149. Underpinning the challenges arising from evidential standards and complexity there might also lie issues of approach. As Tracey McDermott noted, the recent improvement in the FSA's track record in enforcing the criminal sanctions in relation to insider trading related to the priority accorded to it and increased regulatory determination, rather than any change in the law.¹⁸⁷⁰ Professor Julia Black pointed out that one of the most important factors in determining whether the credibility of the enforcement regime was the attitude of regulators:

When people ask me what a regulator should be, I say that they should be three things: they should not be captured; they should not be conned; and they should not be cowed. A lot of what we are trying to drive at here is possibly not so much, 'If we change the sanctions regime, what kind of impact will that have?' but driving the tougher, more credible, and less cowed approach to very powerful individuals who are very successful and very used to getting their own way.¹⁸⁷¹

Professor David Kershaw implied that, taking the case of RBS as an example, enforcement action against individuals might simply have been placed in the 'too difficult' pile:

One thing to focus on is an example of possible poor behaviour where the directors and senior management are clearly on the hook, such as the ABN AMRO decision in the context of RBS. There a decision was taken that, in hindsight, looks highly problematic. Clearly, those directors were involved in making that decision.

He went on to argue that the standards against which individual directors and managers could be held to account were in place and said:

The question then becomes: why haven't they been deployed in relation to that particular example that, on the publicly available facts, looks highly problematic? The answer to that question is that it is still very difficult to prove that someone has not taken the requisite degree of care in making a decision of that magnitude. It is also clear from the public record that you could make such a case. That leads directly to the question: why did the FSA elect not to make that case?¹⁸⁷²

1150. Tracey McDermott indicated that the FSA's methods of investigation often explained the limitations on enforcement:

What you do in an investigation is follow where the lines of inquiry take you. You do different investigations in different ways, but typically you will start working up from the bottom to get through the process, and see which direction you are pointed in, in

1869Q 3021

1870Q 3036

1871Q 2635

1872Q 2641

terms of who are the people with responsibility and who are the people who are aware. You expect people who you are interviewing—if they think that it is not their fault, but that somebody more senior was actually responsible—to point you in that direction. The questions you ask are around where the trail takes you, and where this stops.¹⁸⁷³

This approach can lead to the trail going cold well before it reaches those in the most senior or supervisory positions leading to the emergence of an “accountability firewall”, as discussed in Chapter 3. Martin Wheatley acknowledged the difficulty in holding senior individuals to account:

You have to be able to show the clear evidential trail from a senior figure, a particular abusive decision, to what actually happened. There may be some—I am not saying that [there] will not be any—but in many large organisations it is very hard to provide that evidential trail.¹⁸⁷⁴

1151. Tracey McDermott acknowledged that the FSA had not usually succeeded in holding individuals to account, but told us that the FCA was now focused on correcting this:

The FSA has attempted to hold people accountable. I would accept [...] that we have not succeeded at doing that. We are now looking to see how we can do that better. You can say that we should have done that sooner—that is an absolutely fair point—but I do not think that it is fair to say that that was down to regulatory capture or a lack of integrity on the part of the FSA. [...] It is something which has a huge amount of focus for us, as I have said, across the organisation; not just enforcement. I am confident we will do better.¹⁸⁷⁵

Martin Wheatley also spoke about the FCA's focus on holding individuals to account, but warned that this was a difficult and resource-intensive task:

We have made it a policy that we want more individual accountability, so we are pursuing more cases [...] you will see a change of philosophy and approach, but what I am saying, and being very realistic, is that it is difficult. We have to put a lot of resource into it and it is difficult.¹⁸⁷⁶

Enforcement of civil sanctions: proposals for reform

Rebuttable presumption

1152. In his Introduction to the FSA's Report on the failure of RBS, Lord Turner proposed one way to make enforcement more effective by:

Establishing rules which would automatically ban senior executives and directors of failing banks from future positions of responsibility in financial services unless they

1873Q2263

1874Q 4496

1875Qq 3005, 3007

1876Q 4497

could positively demonstrate that they were active in identifying, arguing against and seeking to rectify the causes of failure.¹⁸⁷⁷

He told us that he believed such an automatic mechanism was needed because of the inherent difficulty of proving an individual responsible:

I am much more attracted [...] to sanctions that have a degree of automaticity, and which affect a large number of people, rather than trying to pin it on one person [...] I honestly feel, having looked very carefully at how these processes of legal proof work, that it will always be difficult in courts of law to have people proved directly responsible for prudential problems going wrong.¹⁸⁷⁸

1153. In July 2012, the Treasury published proposals to introduce a mechanism along these lines, by creating a "rebuttable presumption that a director of a failed bank is not suitable to be approved by the regulator as someone who could hold a position as a senior executive in a bank".¹⁸⁷⁹ The FSA supported the Treasury's proposal:

we would welcome an effective rebuttable presumption and believe that this would send a clear message that Parliament views the failure of a bank as a very serious matter with significant consequences for the careers of those senior figures involved in the failure. If successfully implemented, the rebuttable presumption should make it easier and more efficient for us to reject someone whose involvement with a past failure makes them unsuitable to hold another senior position in the financial services industry.¹⁸⁸⁰

Lord Turner argued that the great strength of the proposal for a rebuttable presumption was its automatic nature. By removing discretion from the regulator on whether to pursue an action, it removed the challenge of having to prove individual culpability.¹⁸⁸¹

1154. The proposal for introducing a rebuttable presumption has met with a number of objections. First, the Financial Services Consumer Panel argued that "the presumption of guilt rather than innocence of directors of failed banks [...] offends notions of natural justice and due process".¹⁸⁸² This concern was echoed by Gregory Mitchell QC, who believed that a rebuttable presumption would be "wrong in principle", arguing that the resulting penalty was significant enough to require "proof of wrongdoing". He pointed out that "A director who was entirely innocent of any wrongdoing might be unable to afford the cost of rebutting any such presumption and be unable to work".¹⁸⁸³ The Law Society expanded on this concern:

Individuals may struggle to gather the evidence necessary to rebut the presumption if they have already left the bank and no longer have access to documents and other

1877FSA Board Report, *The Failure of the Royal Bank of Scotland*, December 2011, p 9

1878Q 4495

1879HM Treasury, *Sanctions for the Directors of Failed Banks*, 3 July 2012, para 3.11

1880Ev 1477

1881Q 4495

1882Ev 1071

1883Ev 1586

relevant material. The problem is particularly acute where the cause of a bank's failure is a complex set of inter-related circumstances, some of which may have been outside the control (and possibly the knowledge) of a particular director. Gathering such evidence could be time-consuming and costly, and in some cases not possible at all for individual directors. This may mean that the director is unable to prepare a proper case to rebut the presumption, which raises obvious issues of fairness.¹⁸⁸⁴

1155. Concern was also expressed about the effects that an automatic mechanism of this kind would have on management challenges of a failing bank. The Financial Services Consumer Panel suggested that “such a mechanism might have a perverse effect, discouraging the far-sighted and diligent from accepting key management positions”.¹⁸⁸⁵ The Law Society also noted that a mechanism which applied to all directors at the point of failure could have perverse effects on banks facing difficulties, because “directors might be incentivised to abandon a distressed bank before it failed” and it could also “lead to difficulties in recruiting well-qualified people to try to rescue failing banks”.¹⁸⁸⁶ Andrew Bailey also observed that a rebuttable presumption “may hinder our ability to ask good people to go into firms in difficulty, something that we do quite often—I would therefore not favour this approach”.¹⁸⁸⁷ The Law Society noted that trying to address the first of these problems by extending the presumption to directors who had left the failed bank would carry its own problems, most notably that it could cause disruption for any banks to which such directors had subsequently moved.¹⁸⁸⁸

1156. Questions were also raised about the scope of a rebuttable presumption. The Treasury's proposal was restricted to directors of failed banks. When we raised the point that there may be cases where senior executives who are not directors are to blame for a failure, Lord Turner responded that other senior managers could be included in the proposal: “I did not intend it that was limited to the board. It includes, but is not limited to” the board.¹⁸⁸⁹ A bank could be considered to ‘fail’ if the regulator judges it to no longer meet threshold conditions, thereby triggering entry into Special Resolution Regime under the Banking Act 2009, but Andrew Bailey pointed to definitional problems with failure:

it will often be difficult to determine when a firm is said to have failed. Our experience suggests that the seeds of firm failure are often sown by decisions which are made long before the firm is placed into the resolution process, or public funds are used to support it.¹⁸⁹⁰

1157. In view of the problems identified with the scope of the rebuttable presumption as proposed by the Treasury, Andrew Bailey proposed an alternative approach involving

1884Ev 1192

1885Ev 1069

1886Ev 1193

1887Ev 1499

1888Ev 1189

1889Q 4499

1890Ev 1500

reversing the burden of proof in cases where a significant failing has been identified. This would require an approved person who had responsibility for a particular area to show that they had taken all reasonable steps to avoid the failing concerned. The FSA believed this would make clear to approved persons that delegation of authority does not equate to delegation of responsibility or allow the person concerned to avoid accountability if something goes wrong.¹⁸⁹¹

Sir David Walker make a similar proposal:

It may be that the regulators should have greater capability to reverse the burden of proof and say that a senior executive who had been involved in a palpable failure would be struck off unless he could show that he had been effective, diligent and challenging in seeking to avert that failure. This is relevant to directors on bank boards and senior executives. That is not a power that is currently available to the FSA. I would invert and give them greater power.¹⁸⁹²

1158. Tracy McDermott also made the case for linking a rebuttable presumption to a concept of responsibility:

We currently state that we will not discipline someone simply because something went wrong in an area for which they were directly or indirectly responsible. We could look to reverse that position by introducing a rebuttable presumption that, in certain circumstances and for particular types of misconduct, where something goes wrong in your area you are responsible unless you can demonstrate that you took all reasonable steps to avoid the misconduct and/or that there were no other reasonable steps that could practically have been taken.

[...] It would be helpful for the regulator in that the starting point would be that the relevant person would have to establish why the steps taken met the standards and respond to any areas of challenge where the regulator identified that other steps could have been taken. This would shift, in a significant way, the nature of the investigation and would in itself have an important signalling effect.

She emphasised that such a change would not short-circuit the requirements of a full investigation:

In order to meet requirements of fairness it would be necessary to ensure that the presumption could actually be rebutted. Although it should enable investigations to be more focussed and limit the areas on which expert evidence is required it would not avoid the need for detailed and complex consideration of the steps taken by the relevant individuals.

She noted that such a change would almost certainly require legislative change to give the regulators a clear foundation for imposing “evidential burdens” on those potentially subject to disciplinary action.¹⁸⁹³

1891Ev 1499

1892Q 3578

1893Ev 1057

Interim prohibition

1159. A second proposal for reform made by the FSA related to the period pending the completion of an investigation:

a regulatory power to prohibit an individual on an interim basis from performing controlled functions [...] would be a significant tool which would allow the regulators to act swiftly to counter any threat to their objectives by an approved person remaining in position pending an appeal.¹⁸⁹⁴

Such a power has parallels with other professions such as medicine, where doctors can be suspended during an investigation in order to limit the risk of harm to patients.¹⁸⁹⁵

1160. In making the case for a power of interim prohibition, Tracey McDermott referred to the time taken for the full enforcement process, citing an instance relating to the director of a stock-broking company:

Even if you take the time from [...] the end of the FSA's internal decision making through the tribunal, we have a case when it took one individual [...] two years and 11 months to go through that. Until that process is finished, he is not prohibited. That is an extreme example, but most cases take well over a year and usually closer to two years in the tribunal.¹⁸⁹⁶

She argued that such delays could mean that an individual could continue to work in the industry while there were significant concerns of which the public might be unaware:

Many of them may not be working in the industry any more, and many employers will dismiss them at least at the end of our decision-making process, if not before, but as they are not on the register as prohibited, the warnings to the public who may deal with them are not there. That is the key issue: there can be an extended period when someone we have serious concerns around is still on the register.¹⁸⁹⁷

1161. The FSA acknowledged the need for appropriate safeguards to ensure that an interim prohibition power would be properly used:

- Primary legislation would need to set out an appropriate threshold that the regulators would need to satisfy before it could exercise this power;
- The power could be exercised through the Supervisory Notice process which would give the subject an immediate right to refer the matter to the Upper Tribunal as well as the right to make representations to the regulator.¹⁸⁹⁸

1894Ev 1061

1895GMC, *Imposing Interim Orders: Guidance for the interim orders panel and the fitness to practise panel*, 14 February 2012, www.gmc-uk.org

1896Q 3038

1897*Ibid.*

1898Ev 1474. Section 133(3) of FSMA already allows the Tribunal Procedural Rules to make provision for suspending a decision of the FCA/PRA pending determination of the reference or appeal.

1162. Andrew Bailey thought that interim prohibition “would need to be carefully drafted to ensure the rights of the individuals are adequately protected, and I think could be quite difficult to put in to effect for the same reasons”.¹⁸⁹⁹ The BBA also noted that appropriate safeguards and compensation arrangements would be required:

We see a case though for the circumstances in which such a facility could be utilised being well defined and the application of suitable safeguards including a high expectation that full prohibition will be the outcome once due process has been completed. We also see grounds for compensation in the event that the regulatory action subsequently proves unjustified.¹⁹⁰⁰

Changing the limitation period

1163. Under current legislation, for a regulator to be able to take action against an Approved Person it must issue a warning notice against them within three years, starting from the date that the regulator becomes aware of the offence.¹⁹⁰¹ The FSA proposed that this limitation period be extended:

three years is likely to be insufficient time for the PRA or FCA to determine whether there is a case to answer in complex cases, some of which may require information from overseas. This can include action taken against senior managers of large firms where the regulators will need to establish personal culpability on the part of those managers for their actions or omissions. Such cases often lead to the regulators having to obtain and process significant volumes of information, which can take a great deal of time.

The time limit can mean that the investigation into the individual’s conduct is truncated, making it more difficult for the regulator to pursue its case. In extreme circumstances, this can mean that if the regulator is not in a position to issue a warning notice within the three year time period then no action can be taken against the individual concerned.¹⁹⁰²

The FSA noted that no time limits apply to market abuse cases, or to disciplinary action against firms. They queried why senior managers, responsible for the conduct of their firms, “should benefit from a limitation period for action particularly when cases are often more difficult to bring against individuals than they are to bring against firms”.¹⁹⁰³ The FSA stated that the limit:

has informed our decision in several cases not to commence an investigation where the appropriate outcome would have been a disciplinary sanction but not a prohibition. In other cases, we frequently have to make difficult decisions to streamline or limit our investigation in order to ensure that we meet the time limit -

1899Ev 1499

1900Ev 876

1901Financial Services and Markets Act 2000, Section 66(4)

1902Ev 1045

1903Ev 1061

this creates litigation risk and means that we may not put forward as strong a case as we might otherwise be able to.¹⁹⁰⁴

The FSA also pointed out that holding senior managers more to account will result in regulators taking on “increasingly complex cases which will take time to investigate to the standard required”.¹⁹⁰⁵

1164. The BBA opposed an extension, arguing that a three year limit “should be viewed as providing suitable discipline upon the regulatory authorities to progress an action reasonably”. They went on to argue that “if anything the timeframe should be shortened”, on the grounds that this would ensure enforcement action concluded more rapidly and because of “the significant impact such action can have over the livelihood of Approved Persons and their families, in circumstances where some will not be found to have been ultimately culpable”.¹⁹⁰⁶

Civil sanctions and powers of enforcement over individuals

Why action is needed

1165. 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.

1166. 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.

Paving the way for a new approach

1167. 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

¹⁹⁰⁴Ev 1479

¹⁹⁰⁵*ibid.*

¹⁹⁰⁶Ev 876

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.

1168. 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.

1169. 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.

Taking responsibility

1170. 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.

1171. 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.

1172. 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.

1173. 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?

A new offence: the need

1174. A number of ‘financial crimes’ already exist relating to money laundering, insider dealing, market abuse, misleading statements and fraud or dishonesty. The Serious Fraud Office, for example, is able to investigate and prosecute investment fraud, corporate fraud and public sector fraud under the Fraud Act 2006, the Theft Act 1968, the Proceeds of Crime Act 2002 and the Money Laundering Regulations 2007. Individuals are prosecuted under these and other powers. Eleven people were sent to prison in 2012 for insider trading as a result of FSA enforcement actions. The FSA confirmed that a number of individuals connected with LIBOR manipulation were being investigated by the SFO in relation to potential criminal offences.¹⁹⁰⁷ However, the types of offence which give rise to criminal sanctions at present tend mostly to involve individuals or small groups, and do not cover the apparent mismanagement and failure of control by senior bankers which has been at the heart of the recent concerns about standards and culture in banking.

1175. There is a widespread view, reflected in some of our evidence, not only that more bankers implicated in recent failures should have been sanctioned, but also that these sanctions should have included criminal sanctions. Joris Luyendijk summarised this when he said:

the rules themselves are deficient. Otherwise, after the crisis of 2008, a lot of people would have gone to jail. The fact that nobody went to jail after such a breakdown means that there is something wrong with the rules themselves.¹⁹⁰⁸

The Financial Services Consumer Panel stated that it “strongly supports tougher and more effective criminal sanctions for directors of UK banks—and of other financial institutions—in appropriately defined circumstances”.¹⁹⁰⁹ The FSA acknowledged that, in cases where the option of criminal sanctions existed, there were benefits to pursuing that route for its deterrent effect:

One element of the FSA’s credible deterrence strategy over the past few years has been to pursue criminal prosecutions for insider dealing and market manipulation in appropriate cases notwithstanding that the FSA also has the ability to bring regulatory cases for market abuse under FSMA. This is based on the belief that the threat of a custodial sentence is a greater deterrent than the threat of a financial penalty.¹⁹¹⁰

The Treasury consultation

1176. Following the FSA’s report into the failure of RBS in December 2011, the Government consulted on proposals to extend the current criminal regime by creating a

1907Q 2312

1908DQ 95

1909Ev 1069

1910Ev 1476

new offence geared specifically to the circumstances of the banking industry. In July 2012, the Treasury published a consultation on creating a new criminal offence of serious misconduct in the management of a bank. The Treasury's proposal for a new offence of managerial misconduct in a bank considered four main possibilities for the kind of managerial misconduct by bank directors and senior management that might be subject to new criminal sanctions:

- Strict liability—being a director at the relevant time of a failed bank;
- Negligence—failure in a duty of care which leads to a reasonably foreseeable outcome;
- Incompetence—failure to act in accordance with professional standards or practices;
- Recklessness—failure to have sufficient regard for the dangers posed to the safety and soundness of the firm concerned or for the possibility that there were such dangers.¹⁹¹¹

The standard for a new offence

1177. Strict liability for directors of failed banks would be similar to the rebuttable presumption examined earlier, in that it would involve an automatic mechanism. However, it would go a big step further because it would remove the right to a defence and make being a director of a failed bank itself a criminal offence. It might create stronger incentives to avoid failure, but it might also recreate, in magnified form, some of the problems and perverse incentives already identified with the rebuttable presumption, such as the incentive to jump ship ahead of failure and the difficulty of attracting directors to a bank that is facing difficulties. The Treasury consultation recognised that imposing severe criminal penalties on individuals who “were not plainly at fault would be controversial”.¹⁹¹² Professors Black and Kershaw observed:

In other areas of regulation where there are strict liability offences, for example in health and safety or environmental regulation, the result has been that the sanctions imposed have often been negligible. This weakens the deterrent effect and diminishes the stigma attached to the criminal liability standard.¹⁹¹³

The FSA echoed this view:

custodial sentences may be less likely if the offence of mismanagement were a strict liability offence, due to the absence of the element of personal culpability.¹⁹¹⁴

1178. Some witnesses argued that neither negligence nor incompetence were sufficiently rigorous standards to support criminal convictions. Professors Black and Kershaw referred to a Law Commission recommendation that

¹⁹¹¹HM Treasury, *Sanctions for the Directors of Failed Banks*, 3 July 2012, para 4.3

¹⁹¹²*Ibid.*, para 4.4

¹⁹¹³Ev 821

¹⁹¹⁴Ev 1476

criminal liability should only be imposed where there was a ‘harm-related moral failure’ and not simply to act as a deterrent. Individuals should not be subject to criminal liability unless their wrongdoing was knowing or reckless.¹⁹¹⁵

Professors Black and Kershaw also noted that, even if a criminal offence using these standards were created, in practice courts would be likely to be unwilling to impose meaningful penalties as a result.¹⁹¹⁶ They concluded that the preferable standard for imposing criminal sanctions would be recklessness, which was a more established and tested basis for judging an offence in English law.¹⁹¹⁷

1179. Tracey McDermott told us:

A criminal offence will have a real deterrent impact and satisfy public concerns only if it can be practicably prosecuted. There are some big issues of fairness and individual rights in relation to criminalising bad business decisions. There are various stages along the spectrum in relation to business decisions, but it is a very big step to say that we should criminalise incompetence or negligence. It is a much wider question than simply whether the public are angry about this.¹⁹¹⁸

She went on to say:

Recklessness is much more familiar to the criminal law, so it is less of an issue. You can be prosecuted for recklessness.¹⁹¹⁹

Practical considerations

1180. In its consultation document of July 2012, the Treasury identified a number of practical considerations to be considered in securing criminal convictions:

- The necessity to establish causation;
- The need to decide who to prosecute;
- The complexity and range of the material that would to be examined, so that “investigations would be extremely costly, and result in prosecutions that could run into years rather than months”.¹⁹²⁰

As discussed earlier in this chapter, it is the difficulty of proving individual culpability which already represents the greatest barrier to imposing individual civil sanctions. The FSA pointed out the main obstacle to the successful use of criminal sanctions:

¹⁹¹⁵Ev 822

¹⁹¹⁶*Ibid.*

¹⁹¹⁷Qq 2628, 2645, 2647, 2820

¹⁹¹⁸Q 3034

¹⁹¹⁹Q 3035

¹⁹²⁰HM Treasury, *Sanctions for the Directors of Failed Banks*, 3 July 2012, paras 4.14–4.17

For a criminal case the evidential burden will be even higher. There is, therefore, a risk that a criminal offence of mismanagement however constructed would rarely be prosecuted and consequently lose its deterrent value through its lack of use.¹⁹²¹

Tracey McDermott added:

we invested a significant amount of time and resource into the investigations we did into the failed banks, but we were not able to establish the evidence necessary to take regulatory action, so even if there had been a criminal offence on the statute book, that would not have got us there [...] a note of caution has to be sounded that this will not be an easy offence to prove [...] If the evidence is not there, it will not be there for criminal cases in the same way as it won't be there for regulatory cases. You can debate whether we got that call right or wrong, but ultimately the evidential standard is higher in criminal cases rather than lower.¹⁹²²

To these practical considerations might be added another, namely that the possibility of criminal action, with the associated risk of prejudice, might greatly inhibit the publication of information about a particular sets of problems within a bank until such time as it is a decision is taken on whether the criminal path will be followed.

A punishment that fits the crime

1181. In consulting on a possible criminal sanction for a criminal offence last year, the Treasury made no reference to the possible penalties for commission of the offence.¹⁹²³ Wide-ranging civil penalties, including large fines and effective denial of livelihood, are already available to the regulator. It might therefore be thought that the penalties for any criminal offence might need to be significantly different to make it worthwhile to seek to overcome the practical barriers facing an attempt to secure a conviction, unless it were felt that the stigma associated with criminal conviction alone warranted such action. Sir Donald Cruickshank argued for severe penalties to be available for an offence: “the penalties for individuals would be unlimited fines and up to 10 years in jail”.¹⁹²⁴ Gregory Mitchell QC argued that prison would not be an appropriate response to many of the failures seen in banking:

The wrongdoing that one has seen in the various reports to what led up to the crisis appears to be largely a failure on the part of people who should have known better to exercise a greater degree of care and skill, so the culpability essentially appears to be that of negligence. In our system, people do not generally get sent to prison for negligence.¹⁹²⁵

By way of contrast, the maximum sentence for a director found guilty of consent, contrivance or neglect where a company has been convicted of health and safety offences is

1921Ev 1475

1922Q 3035

1923HM Treasury, *Sanctions for the Directors of Failed Banks*, 3 July 2012

1924Ev 982

1925Q 2627

an unlimited fine and to a prison sentence of up to two years, even in cases where that has led to someone's death.¹⁹²⁶

Conclusions and recommendations

1182. 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.

1183. 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.

1184. 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.

1185. 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.

¹⁹²⁶Health and Safety (Offences) Act 2008

Enforcement decision-making

The challenge

1186. In the previous chapter we considered the powers of enforcement and sanction that are and should be available to regulators. Even when the powers are changed in accordance with those recommendations, there will remain four challenges for the new regulators in the field of enforcement:

- To ensure that a higher priority for enforcement action even when it is not an easy or quick option is embedded, so that it can survive a future era when attitudes to bankers are less severe;
- To reflect the differences between the demands relating to enforcement in the field of banking compared with other areas of financial services, reflecting the particular combination of systemic risk and social utility that is unique to banking, which in turn should lead to the development of enforcement powers specific to the banking sector in accordance with our recommendations;
- To retain the independence and separateness of the enforcement function bearing in mind the high level of engagement by real-time supervisors with the decision-making processes of banks so that the prospect of ex post enforcement does not become a replacement for effective supervisory intervention as problems emerge;
- To secure effective coordination between the enforcement processes of the prudential and conduct regulators.

In this section we consider the current arrangements and make recommendations designed to overcome these challenges.

FCA enforcement and the Regulatory Decisions Committee

1187. Tracey McDermott, Director of the Enforcement and Financial Crime Division of the FSA, told us that the FSA had still not solved the problem of ensuring that senior figures were properly subject to the enforcement process:

The focus on senior management is something that we have talked about a lot in the FSA but we have found it very difficult to bring home the responsibility, particularly in larger firms, to those who are further up because of confused lines of accountability and because of confused responsibility.¹⁹²⁷

On enforcement's interaction with supervisors, Tracey McDermott stated:

The FSA has been very good at ensuring that things do not get swept under the carpet. One of the things that an enforcement investigation has to do is to ensure that factors that are in favour of the individual or the firm are taken into account as well. Inevitably, where there has been interaction with supervision, which the firm thinks

is in its favour, that will be part of it. In terms of how we communicate those lessons internally, it is very much through going back to the head of department or the director of the relevant area in supervision to say, “This is what has come out in this case. We need to think about whether that is just an individual making a mistake or whether it is something about our process and system that does not work.”¹⁹²⁸

1188. Within the FSA and now the FCA, the enforcement process generally begins with an internal referral to the Enforcement and Financial Crime Division for investigation. Staff from the referring department and the Enforcement and Financial Crime Division will work together to reach an initial decision. If a referral is made to the Enforcement and Financial Crime Division, investigators are appointed and scoping discussions with the firm or individual begin. At the end of the investigation stage a preliminary findings letter, usually together with a Preliminary Investigation Report (PIR), is sent by the Enforcement and Financial Crime Division to the person under investigation. If the Enforcement and Financial Crime Division decides to proceed, the matter is submitted to the decision maker (in most enforcement actions this will be the Regulatory Decisions Committee (RDC)).

1189. The RDC is a committee of the FCA Board and is answerable to the FCA Board. It reports to the Board via the Risk sub-committee, with a direct right of access to the Chairman and the whole Board in the event of any major difficulties. The RDC also has its own legal advisers and support staff. All RDC staff are separate from the FCA staff involved in conducting investigations and making recommendations to the RDC. The procedures of the RDC are designed to ensure that there is an appropriate degree of separation from the enforcement case team. All substantive communications between the Enforcement and Financial Crime Division case team and the RDC must be disclosed to the firm or individual. The RDC has its own dedicated legal function. Therefore, the RDC does not take advice from lawyers in the Enforcement and Financial Crime Division. After the giving of a warning notice or first supervisory notice there cannot be any subsequent meeting or discussions between the Enforcement and Financial Crime Division case team and the RDC while the case is still ongoing without the firm or individual not being present or otherwise having the opportunity to respond.¹⁹²⁹

1190. The RDC is outside the FCA’s management structure and, apart from the Chairman, none of its members is an FCA employee. The members of the RDC are appointed by the FCA Board for fixed periods. In April 2013, the RDC comprised an Acting Chairman, two Deputy Chairmen and eight other members. Their biographies on the FCA website indicate that three are qualified lawyers, including one with judicial experience. The other members have backgrounds in audit, consultancy, client management, the insurance industry and the actuarial profession. The RDC will not seek to invite a member to join a particular panel to consider a case where that member has a conflict of interest and RDC members who have potential conflicts of interest are required to disclose them. The FCA Board may remove members of the RDC, but only on grounds of misconduct or incapacity. The members’ function is to represent the public interest and the FSA has

1928Q 3051

1929Morgan Lewis, *A summary of the Financial Services Authority’s enforcement procedures in the United Kingdom*, April 2006

previously indicated that the intention is that the RDC's membership includes current and retired practitioners with financial services industry skills and knowledge as well as non-practitioners. In April 2013 there was no member of the RDC who did not have either a legal background or a background in the financial services industry.¹⁹³⁰

PRA enforcement

1191. The PRA has stated that its “preference will be to use its powers to secure ex ante, remedial action” which if successful “should mean that enforcement actions are rare”.¹⁹³¹ However, it does have a set of enforcement powers analogous to those of the FCA for breaches of regulatory requirements. Graham Nicholson, Chief Legal Advisor at the Bank of England, told us:

I see enforcement, in the context of the PRA, as being closely related to supervision. I think you will see from our supervision approach document published in the autumn that our focus is very much on accountability, on the management of risks, and the duty of directors, not simply to look at their bottom line but to ensure that they run a safe and sound institution.¹⁹³²

1192. In a consultation on PRA supervisory and enforcement powers, the FSA stated:

A key element of the PRA's regulatory approach will be the personal responsibility of a PRA-authorised firm's board of directors and senior management to ensure that the firm is run prudently.

Where a PRA-authorised firm, Approved Person (or a person performing a controlled function without approval), or a qualifying parent undertaking acts in breach of PRA requirements, a financial penalty can act as a direct and quantifiable punishment for the breach. Further, it may provide an incentive to other firms and persons to effect behavioural changes, as well as those who are subject to enforcement action by the PRA. Responding to actual breaches of the PRA's requirements, as well as dis-incentivising future breaches, may therefore ultimately aid the PRA in advancing its general objective.¹⁹³³

1193. The most obvious cases for PRA enforcement will be where a bank has failed and there is evidence of mismanagement. In our Report on HBOS we concluded that simply suspending the Approved Persons status of senior managers in respect of their HBOS roles was clearly inadequate, and that the regulator should consider removing their right to operate within the financial services sector as a whole. In cases where there have been serious prudential problems that have fallen short of failure, the PRA may have an incentive to rely on supervisory actions and informal pressure to replace key people rather than pursuing formal enforcement action against responsible individuals, for fear of

¹⁹³⁰“RDC Members biographies”, FCA, www.fca.org.uk

¹⁹³¹Bank of England, Prudential Regulatory Authority, *Our approach to banking supervision*, May 2011, para 80, www.bankofengland.co.uk

¹⁹³²Q 3047

¹⁹³³Bank of England, Prudential Regulation Authority, *The PRA's approach to enforcement: consultation on proposed statutory statements of policy and procedure*, December 2012, paras 3.2 and 3.3, www.bankofengland.co.uk

destabilising the firm. Given that the number of prudential enforcement cases may well be influenced by the economic cycle, there is also an interesting question about how the PRA will resource its enforcement team and maintain the necessary expertise over time, in comparison to the FCA where misconduct cases might be expected to be less cyclical. The Bank of England said:

There will be cases that have a bearing on “safety and soundness” of an institution and the competence or integrity of its senior management which the PRA will be keen to pursue, but which may not give rise to issues of concern to the FCA; the PRA would pursue such cases on its own. The PRA will have its own enforcement capability to enable it to act on its own where this is necessary, drawing on external expertise as required.¹⁹³⁴

Cooperation between the regulators

1194. The FSA’s Approved Persons regime and enforcement powers have been split between the FCA and the PRA, and the two bodies will have to coordinate how the regime operates given the potential for overlap or conflicts.¹⁹³⁵ The FCA has inherited the majority of the staff currently working on enforcement, including its current head of division Tracey McDermott. Graham Nicholson told us that the PRA will be reliant to some extent on the FCA’s resources and experience.¹⁹³⁶ He assured us that the PRA and FCA “have worked-up detail below the level of the rather broad MOU, particularly in relation to enforcement actions”,¹⁹³⁷ although the effectiveness of these arrangements has yet to be tested over time. The MoU in question sets out that:

Senior official from the FCA and the PRA responsible for enforcement and legal interaction respectively will meet quarterly to discuss potential and ongoing enforcement actions against relevant firms [...] Any significant public communications related to the general approach to enforcement or related policy that may materially affect the other’s objectives will be notified to the other regulator.¹⁹³⁸

Conclusions and recommendations

1195. In established professions, a number of steps are taken to separate disciplinary functions from supervision of professional development. In the legal profession, for example, the Solicitors Disciplinary Tribunal is “totally separate” from the Solicitors Regulation Authority (SRA) and has a mixture of lay and professional members. The SRA has no say in its composition; it is in effect a prosecutor before a tribunal.¹⁹³⁹ Sir Peter

1934Ev 798

1935FSA, *Regulatory reform: the PRA and FCA regimes for Approved Persons*, October 2012, www.fca.org.uk; FCA, *The new FCA Handbook*, PS 13/5, March 2013, www.fca.org.uk; PRA, *Regulatory reform: amendments to the Prudential Regulation Authority Handbook*, PS1/13, March 2013, www.bankofengland.co.uk

1936Q 3047

1937Q 3048

1938Bank of England, *Memorandum of Understanding between the FCA and the PRA*, paras 47 and 49, www.bankofengland.co.uk

1939Q 1804

Rubin, who chairs the General Medical Council, described similar recent developments in the medical profession:

Following the Shipman inquiry, it was pointed out to the GMC by Dame Janet Smith that our previous arrangements, whereby we were the police, the Crown Prosecution Service, the judge, the jury and everything else, was incompatible with Article 6 of the Human Rights Act. Essentially, no one should be a judge in their own cause. So last year we hived off our adjudication processes, by which cases against doctors are heard, to a separate body in a separate building. It is funded by us but, crucially, it is run by a judge. They now run the adjudication process. The final bit of the jigsaw is we are asking Parliament to give us the power to appeal when we do not agree with one of its findings. That would really get the complete separation going.¹⁹⁴⁰

1196. One possible approach to resolving the tensions caused by having supervision and enforcement side-by-side within the same organisation could be to move enforcement powers out of the FCA and PRA to another body. Such a structure could also be the eventual outcome of establishing a new standards body with enforcement powers, such as the Banking Standards Review Council proposed by Barclays and the BBA.¹⁹⁴¹ However, we concluded earlier in this Report that the industry is a long way from being at the stage where the assumption of disciplinary powers by an autonomous, self-governing professional body or a distinct sister body of such an organisation would be appropriate.

1197. A single statutory body with a sole focus on enforcement could provide a number of benefits. It could help address the possibility of conflict or missed opportunities from divided responsibilities between the FCA and PRA. It should be able to structure itself in a way which better delivers effective enforcement, rather than having to fit into the structure and staff policies of a broader regulator. It would have clearer objectives and accountability. It could address the risk of conflicts of interest with supervisors and could find it easier to initiate investigations without a referral from supervisors. It could free the remaining supervisory body to focus on day-to-day supervision and risk mitigation, and could generate some useful accountability and feedback channels that could force the supervisors to become more effective. A new enforcement body would represent more of a clean break with the past and assist with more radical changes to the Approved Persons regime.

1198. However, there would also be significant obstacles to such a move, not least because it would generate a new regulatory body which could be a source of confusion and conflict. An independent enforcement body would still be reliant on supervisors for many referrals, which could result in fewer cases if there were any problems cooperating with the FCA or PRA. Careful consideration would need to be given to what the scope of a new body would be, in particular whether it should take both individual and firm-level enforcement and whether it should cover the whole financial services sector or just banking.

1199. 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,

¹⁹⁴⁰*ibid.*

¹⁹⁴¹Ev 809, 852

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.

1200. 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.

1201. 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.

1202. 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.

11 The way forward

1203. In its mid-term review, the Government has made the following, welcome commitment:

We will introduce any necessary amendments to legislation arising out of the Parliamentary Commission on Banking Standards, including any necessary new criminal offences and associated penalties.¹⁹⁴²

The Government has also made clear that it intends to use the Bill now before the House of Commons for giving effect to legislative proposals arising from this Commission's work.¹⁹⁴³

1204. As we noted earlier, the Chancellor of the Exchequer and the Secretary of State for Business, Innovation and Skills have endorsed the concept of far reaching reforms of banking. The Commission concludes that the recommendations in this Report are far-reaching and provide the basis for the root and branch reform of the banking sector that is needed. Taken together, if fully implemented, they provide a unique opportunity to transform and reinvigorate the standards and culture of the UK banking sector for generations to come, with considerable benefits for the economy as a whole. The political will to effect a transformation in UK banking in response to the failures in its standards and culture partly derives from the understandable sense of public anger at what has happened in banking in recent years. This sense of anger is deep-rooted, but it will abate. When it does so, those who resist change, who argue that banks should be left alone, that the time for remorse has passed, will renew their pleas for inaction shrouded in cosmetic change. For these reasons, it is essential that the momentum for reform is maintained.

1205. The Commission has made a large number of proposals for legislative and regulatory action. We have not usually specified whether they require primary legislation. The Commission recommends that in its response to this Report the Government, in cooperation with the regulators, set out the timetable for implementation of each of our recommendations, and specify those that will require primary legislation. As a general rule, we consider that those recommendations requiring primary legislation should be implemented through amendment to the Financial Services (Banking Reform) Bill. In any case where the Government does not propose to implement a recommendation requiring legislative action through an amendment to that Bill, the Commission recommends that, in its response to this Report, it set out its plans for taking forward such legislation.

1206. The Deputy Leader of the House of Commons recently noted:

Of course it is important to ensure that change in the banking sector is carried through, both through the Government's commitment to introduce any necessary amendments to legislation arising out of the Commission's work, and through

¹⁹⁴²HM Government, *The Coalition: together in the national interest: Mid-Term Review*, January 2013, p 13

¹⁹⁴³First Report, para 9

appropriate parliamentary scrutiny of progress in the banking sector and its regulation after the Commission ceases.¹⁹⁴⁴

In the first instance, we expect that the detailed task of monitoring progress in the banking sector and its regulation, along with steps taken to implement the Commission's recommendations, will fall to Parliament. It will also be for Parliament to consider whether the rate of progress, or its absence, within the UK banking sector merits the establishment of a successor to this Commission at some time in the future.

1207. There have been three waves to the crisis: the 'fire-fighting' phase, when financial stability and the future of the UK economy itself was on the line; the phase of structural change, in which the Independent Commission on Banking carried out its work and in which the system of regulation has been recast; and the more recent period, in which the country has learnt even more about the depth of the roots of the crisis and of the scale and variety of the failures of standards in the banking industry. It was this third phase that was the immediate cause of our creation and which has particularly informed our approach.

1208. **The proposals of this Commission can do much to enable the Government, regulators and above all the industry itself to remedy the shortcomings in standards set out in this Report. The challenge for Government is to follow through on the commitment to far-reaching reform. The challenge for regulators, in implementing planned reforms and the Commission's proposals, is to give substance to their commitment to a greater exercise of judgement.**

1209. **The greatest challenge lies with the banks. It also represents a great opportunity. By making constructive use of the recommendations of this Report and by supporting their spirit as well as the letter, the banks can, over a period, earn the respect of the public, and thereafter regain their trust. Everyone can be the beneficiary. Implementation of the agenda we have set out for higher standards will lead to an industry which better serves both its customers and the needs of the real economy. It will also further strengthen the position of the UK as the world's leading financial centre. If implemented, our proposals can change banking for good.**

Annex 1: Conduct of our work

Overview

1. The establishment of an ad hoc committee of the two Houses to examine a major public policy issue is a highly unusual step. The scale and speed at which we were expected to report on our remit required that we work in a new way. The Commission itself held 40 public evidence sessions. We established panels, with between one and five members of the Commission, to gather evidence on detailed, specific aspects of banking standards, or to conduct case studies which illuminated broader banking standards issues. On certain occasions, the Commission and its panels as a whole exercised the power we had been given by the two Houses to use Counsel to assist in the examination of witnesses. The Commission and its panels also gathered a considerable amount of written evidence. In this Report we have referred directly only to a small proportion of that evidence. Some has appeared in earlier reports, and the evidence is reproduced in full, accessible at www.parliament.uk/bankingstandards. We are most grateful to all those who have contributed to our work, including those who gave oral and written evidence, and to our Specialist Advisers.¹⁹⁴⁵

2. This is the fifth Report of the Commission.¹⁹⁴⁶ Our *First Report* reflected on pre-legislative scrutiny of the draft Financial Services (Banking Reform) Bill, undertaken at the request of the Government; our Second Report *Banking Reform: towards the right structure* assessed the Bill published by the Government against the recommendations we had made in our First Report; our Third Report *Proprietary Trading* was produced following the conclusion in our First Report that more evidence was needed before we could make recommendations on proprietary trading; and our Fourth Report, '*An accident waiting to happen*': the failure of HBOS, was a detailed case study of one bank's failure on which we have drawn extensively to inform the proposed remedies which now follow.

Use of Counsel

3. The Commission appointed Counsel to participate in the examination of witnesses, the first use of Counsel by a parliamentary committee as part of a major public policy inquiry. This was used initially for the Panel on HBOS and for the Commission's hearings with former senior leaders of that bank, and subsequently for the Panel on Cross-selling and Mis-selling and for the Commission's evidence with past and current staff of RBS on LIBOR fixing. We also drew upon the expertise of Counsel in the preparation of questions for some other evidence sessions.

¹⁹⁴⁵The following Specialist Advisers were appointed by the Commission: Philip James Ahlquist, William A Allen, Dr Pinar Bagci, Richard E T Bennett, Ian Bond, Sir Richard Broadbent, Sir Alan Budd, Forrest Capie, Richard Harris, Kate Holderness, Anne Jeavons, Christopher Langley, Bill Michael, Rory Phillips QC, David Quest, Adam Tolley, Professor John Willman, Charles Wilson, Bill Winters, and Professor Geoffrey Wood. Justin Welby was appointed as a Specialist Adviser with the power to examine witnesses between 4 February and 26 February.

¹⁹⁴⁶This Report is described on the inside cover of each volume as the First Report of Session 2013–14, because report numbering for these purposes is sessional.

4. Counsel were very helpful in providing the Commission with detailed forensic support. Counsel's examination, for example of disclosures provided to us by Lloyds Banking Group and the FSA in relation to HBOS, was of great benefit in helping us to focus on and examine the most pertinent documents disclosed. Counsel were also able to assist in our requests for disclosure, ensuring that they targeted the most important issues.

5. The power to take evidence under oath was granted to the Commission.¹⁹⁴⁷ We did not, however, feel it necessary to use this power at any time throughout our evidence-gathering process.

Panels

6. We were granted the power to establish evidence-gathering panels of Members.¹⁹⁴⁸ The Commission used panels to focus on detailed issues, and to provide case studies to help inform our recommendations. Panel hearings paved the way for subsequent full Commission hearings in many cases. The membership of panels was self-selecting. The following panels were established:

- a) Panel on the Consumer and SME Experience of Banks;
- b) Panel on HBOS;
- c) Panel on Corporate Governance: Board Level;
- d) Panel on Corporate Governance: Below Board Level;
- e) Panel on Regulatory Approach;
- f) Panel on Retail Competition;
- g) Panel on the Operation of Wholesale Markets;
- h) Panel on Tax, Audit and Accounting;
- i) Panel on Scotland;
- j) Panel on Mis-Selling and Cross-Selling; and
- k) Panel on Financial Exclusion and Basic Bank Accounts.

7. Panels provided us with speed and flexibility. The Panel on the Consumer and SME Experience of Banks was, for example, able to take evidence on one occasion from different departments of three banks ranging from SME Relationship Managers to Retail Banking Regional Directors to Customer Service Executives. We were therefore able to compare and contrast the viewpoints of individuals from the same organisation from several levels of seniority. Our ability to hold sessions in private, although used only on four occasions,

¹⁹⁴⁷HC Deb, 16 July 2012, col 810, para 7b [Commons Chamber]; HL Deb, 17 July 2012, cols 109-110, para 5b [Lords Chamber]

¹⁹⁴⁸HC Deb, 16 July 2012, col 810, para 8 [Commons Chamber]; HL Deb, 17 July 2012, cols 109-110, para 9 [Lords Chamber]

allowed us to obtain an insight into front line experiences of banks without unnecessarily putting junior members of staff into the spotlight.

8. Panels enabled us more quickly to carry out detailed case studies. The Panel on HBOS allowed us to assess the causes of their failure in detail. The Panel on Scotland also carried out a case study of the housing sector. Case Studies gave us the ready ability to understand issues people experienced in different regions of the UK. Panels visited Scotland (on three occasions), Birmingham once and a trading floor in the City of London. On a number of occasions more than one Panel met at the same time.

Other issues

9. The Chairman of the Commission was given a power to report a formal decision of the Commission which was not taken at a formal meeting if he had consulted all Commission members on that decision.¹⁹⁴⁹ This was, in effect, a power to hold ‘virtual’ decision-taking meetings. Only one such meeting was held, on which there was no need to report.

10. The Commission’s secretariat was drawn together at short notice. In addition to parliamentary staff, the Commission benefited from staff drawn from elsewhere in the public sector, including the FSA (later FCA and PRA), the Bank of England, the Treasury, HM Revenue & Customs and the Treasury Solicitor’s Department, and from the private sector. Having individuals from a broad range of backgrounds and institutions who were equipped with both technical and practical experiences of the banking sector was of considerable benefit to our work. The current forecasted additional net cost to the House of Commons Service as a result of the Commission’s creation and work will be approximately £850,000.

¹⁹⁴⁹HC Deb, 16 July 2012, col 810, para 9 [Commons Chamber]; HL Deb, 17 July 2012, cols 109-110, para 8 [Lords Chamber]

Annex 2: Trust in other sectors

1. To some degree, the loss of trust in banking has taken place alongside erosion of trust in other sectors. Other industries have been found wanting. The oil industry is currently being investigated by the European Commission over allegations of price-rigging.¹⁹⁵⁰ As part of its resolution of criminal claims with the US Government arising from the Deepwater Horizon accident, BP will pay \$4 billion, including \$1.256 billion in criminal fines, with a final large civil fine expected to be finalised at the end of this year.¹⁹⁵¹ Pharmaceutical companies have paid more than \$11 billion in fines since 2009 for very serious and unlawful activities including withholding safety data and promoting drugs for use beyond their licensed conditions.¹⁹⁵² These fines have been larger even than those for LIBOR so far announced.

2. The banking sector has not been alone in either suffering from a cultural malaise or finding itself in the public eye for past and more recent failings. For example:

- a) Faith in the BBC has been shaken, both by exposure of historic weaknesses in the culture with regard to the conduct of individuals and by lapses in standards of editorial control,¹⁹⁵³
- b) Public respect for and trust in politicians, never high, collapsed following the Parliamentary expenses scandal;
- c) The Report of the Mid-Staffordshire NHS Foundation Trust Public Inquiry Report has shed light upon what its author characterised as “an insidious negative culture involving a tolerance of poor standards and a disengagement from managerial and leadership responsibilities”;¹⁹⁵⁴ and
- d) Concern at the nature of illegal phone-hacking by certain national newspapers led to the establishment of a public inquiry and subsequent proposals from Lord Leveson, now in the process of implementation, for a different approach to regulation of press activities.¹⁹⁵⁵

3. In addition to these shocks to the faith of the public in once trusted institutions, there is also a deeper underlying change in public attitudes which has been underway for many years. The public is less willing than ever to accept the credentials institutions or sectors on

1950 “Murky oil markets”, *The Financial Times*, 15 May 2013, www.ft.com

1951 “BP announces resolution of all criminal and securities claims by U.S. Government against company relating to deepwater horizon accident”, BP press release, 15 November 2012

1952 “Drug giants fined \$11bn for criminal wrongdoing”, *The Independent*, 20 September 2012

1953 Reed Smith, *The Pollard Review: Report*, 18 December 2012, www.bbc.co.uk

1954 Report of the Mid Staffordshire NHS Foundation Trust Public Inquiry, Executive Summary, HC 947, p 3

1955 Leveson Inquiry: Culture, Practice and Ethics of the Press, www.levesoninquiry.org.uk

trust, and to give the benefit of the doubt to the motives or competence of those in authority. The public's trust now has to be earned.

Annex 3: Bank remuneration

1. Chart 1 in Chapter 3 is based on information about total employee compensation drawn from company reports and accounts. The underlying data is shown in the table below. Barclays 2007/08 figures exclude BGI as a discontinued activity. LBG figures for 2007 and 2008 represent the sum of Lloyds TSB and HBOS. We have added back one-off pension credits of £910m and £250m in 2010 and 2012 respectively. RBS figures are on a pro forma or managed basis. The Barclays figures partly reflect the additional costs from the acquisition of parts of the Lehman Brothers business in September 2008. The LBG figures partly reflect the merger with HBOS in 2009.

Table: Staff compensation costs in large UK banks

(£m)	Barclays	HSBC Bank	Lloyds Banking Group	RBS	Total
2007	7,080	4,305	5,733	9,345	26,463
2008	6,542	4,498	5,914	7,990	24,944
2009	8,894	4,452	6,675	9,081	29,102
2010	10,916	4,961	6,532	8,956	31,365
2011	10,414	4,581	6,166	8,163	29,324
2012	9,786	4,789	5,699	7,639	27,913

2. Chart 2 in Chapter 3 on per capita compensation is based on the data in the table above as well as employee numbers taken from company reports and accounts. The table below shows the underlying data as well as a breakdown of per-capita compensation between the investment banking division and the rest of the bank.

Table: Per-capita compensation costs in large UK banks

£000s	Barclays			HSBC Bank			RBS			LBG
	Barclays Capital	Excl. Barclays Capital	Average	GBM	Excl. GBM	Average	Markets	Excl. Markets	Average	
2007	195	35	54			51	160	37	54	40
2008	124	33	43	104	43	51	116	38	46	42
2009	196	37	62	137	42	54	162	43	56	51
2010	227	43	74	163	49	64	133	52	60	53
2011	199	47	74	150	47	57	141	47	56	51
2012	193	45	70	167	54	65	130	49	56	50

Annex 4: CDFIs

The role of CDFIs

1. We examined various parts of the community finance sector in greater detail, particularly CDFIs. The Community Development Finance Association (CDFA), the trade body representing individual CDFIs, explained to us that CDFIs specialised in serving “customers from groups traditionally recognised as subject to inequity on account of ethnicity, gender, age, creed and other defining characteristics” as well as “providing loans to people who face barriers to accessing finance” such as “individuals with a poor credit history or little collateral, or provide business loans to viable entrepreneurs deemed too risky by mainstream banks”.¹⁹⁵⁶ They explained that CDFIs “usually only lend to customers who have been unable to get the finance they need from a high street loan provider, such as a bank, building society or loan company”.¹⁹⁵⁷

2. We examined some of the key barriers to the growth of community finance and, in particular, the CDFI sector. CDFA told us “the industry is hugely underdeveloped and undercapitalised and therefore incapable of providing community finance to all communities and to all markets across the UK”, but argued that there was scope to grow the sector in the UK, which is far smaller than in the USA.¹⁹⁵⁸ They contrasted the situation in the UK with the USA:

Even the USA, considered a bastion of free market economics, has legislation in place designed to encourage commercial banks to help meet the needs of borrowers in all segments of their communities, including low-and moderate-income neighbourhoods [...]

By way of contrast, the CDFA pointed out that “In the UK, no such policy framework exists to incentivise the commercial finance sector to serve the underserved. Neither does a framework exist to support alternative community finance, and therefore provision of such is grossly inadequate”.¹⁹⁵⁹

3. The Business Enterprise Fund (BEF), a CDFI operating in West and North Yorkshire, expressed concern that “CDFIs have had major difficulties in promoting themselves amongst key stakeholders. At a national level they continually battle with explaining what it is they do and policy makers getting a handle on what they do. Equally regionally they are faced with the same challenges”.¹⁹⁶⁰ They also expressed concern with respect to their relationship with banks:

Sadly their awareness [the banks] of the work CDFIs do and their willingness to collaborate with them is patchy at best, and at worst is obstructive. In the 8 years we

1956 F Ev 99

1957 *Ibid.*

1958 F Ev 103

1959 *Ibid.*

1960 F Ev 129

have been trading we have always felt that a helpful and collaborative relationship with the high street banks would be the perfect relationship to gain access to the market. However, we have constantly struggled to get the level of penetration into declined lending that we would have hoped for. The banks have always been reluctant to provide referrals to CDFIs.¹⁹⁶¹

BEF argued that “in a perfect world all declined clients would be referred as a matter of practice to CDFIs”, but lamented that “this does not happen”. They noted that some CDFIs “have greater success than others”, but said “this was sporadic”.¹⁹⁶²

4. In October 2012 a joint BBA-CDFFA initiative saw the banks signing up to an automatic referral scheme that would send every declined loan, prior to credit committee and after credit committee, to CDFIs. However, CDFFA appeared to suggest that the scheme was not working as well as it should:

The BBA’s own figures state that 5000 loans are declined by the big 5 high street banks every month. These are the loans that have gone to credit committee and do not include the declines that do not get to credit committee, which is estimated to be in the tens of thousands. Since October the BBA have referred to CDFIs in this scheme 24 clients.¹⁹⁶³

5. Another issue raised by CDFIs was access to capital to enable them to scale up their work. BEF told us that “there ought to be some mechanism that would encourage banks and other funders to invest into AFPs and CDFIs that would provide some tax incentives”. Tesco Bank has provided an example by committing £500,000 of loan capital to the Grameen Scotland Foundation which will offer micro-loans to prospective small entrepreneurs in Glasgow, North Ayrshire, West Dunbartonshire and Inverclyde.¹⁹⁶⁴ The CDFFA acknowledged that Community Investment Tax Relief (CITR) was in place to support CDFIs, but argued that it “has not lived up to its promise”.¹⁹⁶⁵

¹⁹⁶¹ *Ibid.*

¹⁹⁶² *Ibid.*

¹⁹⁶³ *Ibid.*

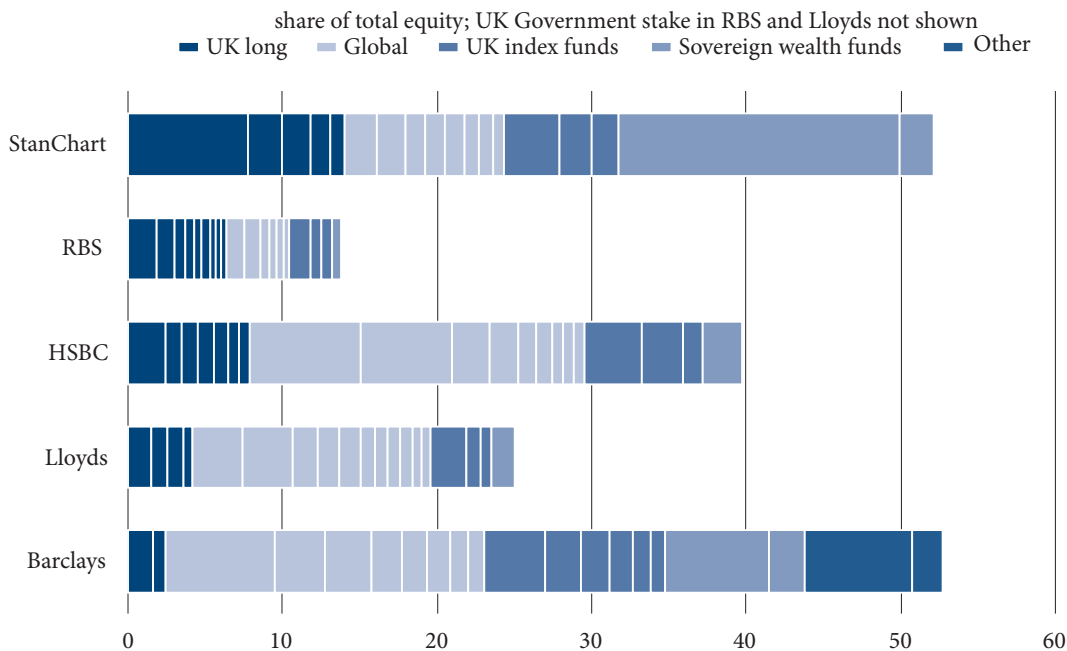
¹⁹⁶⁴ “System that helps entrepreneurs in poor countries to access cash opens in Scotland”, *The Times*, 26 October 2012

¹⁹⁶⁵ F Ev 131

Annex 5: Bank ownership

1. The chart below illustrates the size of the shareholdings of the top twenty investors in each of the five quoted UK banking groups. It paints a picture of a fragmented ownership structure: apart from the shareholdings acquired by the UK Government during its rescue of RBS and Lloyds, the three largest single stakes are the 18 per cent share in Standard Chartered held by Temasek; JPMorgan’s 7 per cent share of HSBC; and Blackrock’s 7 per cent share of Barclays. As in the UK equity market as a whole, institutional investors predominate. Many of these choose to diversify their holdings across a number of banks: nine investors have top twenty shareholdings in each of the five banks.

Top 20 shareholders in listed UK banks



2. As in the rest of the UK equity market, bank shareholders typically have limited interest in the operation of banks, and tend to place a premium on short-term returns. In a speech in 2011, Andy Haldane noted that average holding periods for bank stocks had fallen from 3 years in 1998 to 3 months in 2008, adding that the trend was self-perpetuating:

Investors shorten their horizons. They set ROE [return on equity] targets for management to boost their short-term stake. These targets in turn encourage short-term risk-taking behaviour. That benefits the short-term investor at the expense of the long-term, generating incentives to shorten further horizons. And so the myopia loop continues.¹⁹⁶⁶

Sir David Walker regretted this disengagement and short-termism, expressing a desire for “more long-only shareholders”, and wishing that “more of them took more long-term

¹⁹⁶⁶Bank of England, *Control rights (and wrongs) speech*, Andy Haldane, 24 October 2011, www.bankofengland.co.uk

views and engaged, in line with the propositions in the stewardship code, with the companies in which they invest”.¹⁹⁶⁷

3. Shareholders are limited in their capacity to exercise oversight and engagement, particularly in large and complex financial institutions. Professor Kay commented that “few fund managers have either the competence or the scale of shareholding” to involve themselves in the operational matters of banks,¹⁹⁶⁸ while the IMA argued that, even if shareholders had been more diligent, they would not have identified the problems that led to the financial crisis:

it is now apparent that bank boards and management failed to appreciate fully the risks on their balance sheets, thus, fund managers could not have been expected to either; this was not a problem which could have been avoided by better engagement.¹⁹⁶⁹

4. Many institutional shareholders also lack the *willingness* to perform stewardship roles with respect to either prudential or conduct matters. The ABI noted that shareholders did not have access to the same confidential information that is available to company management, and “do not wish to become insiders, as this would constrain their ability to operate in the market”.¹⁹⁷⁰ It would be regrettable if insider trading provisions and their enforcement have had the side effect of eroding the already limited incentives for institutional intermediaries to be active investors.

1967Q 3628

1968Q 322

1969Ev 1155

1970Ev 742

Annex 6: The public policy framework for remuneration

Origins

1. The failure of the banking industry to address problems with remuneration and the depth of public dismay about high rewards in banking have led to series of public policy interventions on pay. This annex outlines the existing public policy framework.

2. A global initiative, led by the G20, resulted in April 2009 in international agreement to regulate banking pay, culminating in the Financial Stability Board (FSB) Principles for Sound Compensation Practices and their Implementation Standards.¹⁹⁷¹ The Principles “require compensation practices in the financial industry to align employees’ incentives with the long-term profitability of the firm.”¹⁹⁷² The Standards “focus on areas in which especially rapid progress is needed”.¹⁹⁷³ These include linking total bonus pools to the financial performance of the firm, and public disclosure and transparency.¹⁹⁷⁴ Many of the measures discussed below have their origins in the FSB’s Principles and Standards.

The Remuneration Code

Background

3. Following the financial crisis, the FSA acknowledged that remuneration policies had been a major contributory factor. In October 2008, Hector Sants, then Chief Executive of the FSA, wrote to bank Chief Executives about their remuneration policies saying that the FSA wanted “to ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls, and with the firm’s stated risk appetite.”¹⁹⁷⁵ In August 2009, the FSA, with the agreement of the major UK banks, introduced a Remuneration Code. This applied to 26 of the largest UK banks and building societies, and consisted of a “a general requirement for firms to establish remuneration practices that ‘promote effective risk management’ which [was] underpinned by a series of ‘evidential provisions’ or principles and associated guidance.”¹⁹⁷⁶

Update of the Remuneration Code to give effect to CRD III

4. An updated Remuneration Code came into force in January 2011 and continues to apply. The code was updated to implement the provisions of the Third Capital

¹⁹⁷¹Financial Stability Board, Principles and Standards for Sound Compensation Practices, www.financialstabilityboard.org

¹⁹⁷²*Ibid.*

¹⁹⁷³*Ibid.*

¹⁹⁷⁴*Ibid.*

¹⁹⁷⁵Letter from Hector Sants to bank Chief Executives, 13 October 2008

¹⁹⁷⁶Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations*, 26 November 2009, p 107

Requirements Directive (CRD III), which introduced a number of measures to address bank remuneration.

Applicability of the Remuneration Code

5. The Remuneration Code contains conditions for both the firms and the individuals within those firms to which it applies:

- i. **Firm level applicability:** Initially restricted to the largest firms, the Code now applies in some form to all UK domiciled banks, building societies and investment firms. It also applies to the operations of a UK domiciled firm outside the EEA and to the UK branches and subsidiaries of non EEA firms. However, it does not apply to the UK branches of non-UK EEA firms, as they are governed by the respective national regulations that implement CRD III.
- ii. **Individual applicability:** The general principles of the Code apply to the remuneration of all employees of a firm. However, there are specific requirements for the category known as ‘Remuneration Code staff.’ Remuneration Code staff are defined as including: senior management, any employee receiving total remuneration that takes them into the same remuneration bracket as senior management, and any risk takers or control staff (such as risk management, compliance HR and legal), whose professional activities have a material impact on the firm’s risk profile. All staff designated as having Significant Influence Functions under the FSA Approved Persons Regime would normally be expected to be classified as Remuneration Code staff.

The requirements of the Remuneration Code

6. The Remuneration Code sets out rules and associated guidance concerning remuneration structures and the governance and performance measurement used to determine performance-related pay. Firms are also required to disclose details of their remuneration policies at least annually.¹⁹⁷⁷ In determining performance related pay, firms are required to ensure that awards reflect individual, business unit and overall firm performance. Performance assessment should be on a multi-year framework, reflecting the potentially cyclical nature of the business and should also include significant non-financial measures.¹⁹⁷⁸ Box A sets out the Code requirements for variable pay.

Box A: Remuneration Code Requirements for variable pay

- a) at least 40 per cent of variable remuneration must be deferred over a period of at least three to five years, with awards vesting no faster than on a pro-rata basis;
- b) for executive directors of significant firms, or for a ‘particularly high amount’ of variable remuneration, currently defined in the Code as £500,000, a minimum of

¹⁹⁷⁷PRA, Remuneration Code, www.bankofengland.co.uk

¹⁹⁷⁸Remuneration principles for banks, building societies and investment firms, Remuneration Principle 12(b), www.fshandbook.info

60 per cent should be deferred. Lesser amounts could also be considered as a ‘particularly high amount’ depending on the nature and context of the firm;

- c) at least 50 per cent of both upfront and deferred elements of variable remuneration paid to Remuneration Code staff must be in non-cash form, such as shares, share linked instruments, or debt instruments which are eligible to be included as regulatory capital;
- d) at least 50 per cent of awards under long term incentives plans should vest (that is, the recipient becomes entitled to it) after not less than five years, with the remainder only vesting after not less than three years;¹⁹⁷⁹
- e) unvested deferred remuneration should have claw back features and should be reduced in the event of employee misbehaviour or material error, material downturn in financial performance of the business unit or firm, or a material failure in risk management at the unit or the firm.¹⁹⁸⁰
- f) Under the FSA’s ‘proportionality’ principle, the deferral requirements need not apply to Remuneration Code staff, if their variable compensation is less than 33 per cent of their total remuneration, and their total remuneration is also no more than £500,000.¹⁹⁸¹

7. The FSA Code does not use either of the terms ‘malus’ or ‘claw-back’. However, it specifically requires remuneration structures to allow for the reduction of unvested remuneration and states that this should be reduced in the event of inter alia, evidence of misconduct or error, material downturn in financial performance of the business unit or firm, or material risk management failure at the unit or firm. In addition, the firm is required to record decisions concerning how deferred compensation has been reduced if one or more of these events occur.¹⁹⁸²

CRD IV and the ‘bonus cap’

8. The Fourth Capital Requirements Directive, which we consider elsewhere in this Report, is in a late stage of the European legislative process and contains, amongst other things, updated provisions on bank remuneration. It is likely to be implemented during 2014. In this section we consider two elements, the proposed “bonus cap” and increased transparency requirements.

¹⁹⁷⁹Remuneration principles for banks, building societies and investment firms, Remuneration Principle 8, www.fshandbook.info

¹⁹⁸⁰Remuneration principles for banks, building societies and investment firms, Remuneration Principle 12(g), www.fshandbook.info

¹⁹⁸¹Remuneration principles for banks, building societies and investment firms, Remuneration Principle 12, www.fshandbook.info

¹⁹⁸²Remuneration principles for banks, building societies and investment firms, Remuneration Principle 12(h), www.fshandbook.info

Bonus cap

9. While the existing Remuneration Code requires that the ratio between fixed and variable should be balanced, such that the fixed component represents a sufficiently high proportion of the total remuneration, to allow no variable remuneration to be paid,¹⁹⁸³ CRD IV introduces a direct link, limiting variable remuneration to 100 per cent of fixed pay. This can be increased to a maximum of 200 per cent of fixed pay if shareholders approve. This requires either at least a 66 per cent majority of shareholders, with at least 50 per cent of participation of those eligible, or at least 75 per cent of those voting. If a ratio of more than one times fixed remuneration is approved by shareholders, 25 per cent of the variable remuneration must be paid in long-term deferred instruments. A number of conditions apply to these instruments, including that the deferral period for such instruments must be a minimum of five years.

Transparency requirements

10. CRD IV also increases remuneration disclosure requirements. Banks will now be required to disclose the number of employees earning between €1 million and €5 million, broken down in bands of €0.5 million, and above €5 million, broken down by bands of €1 million. Increased disclosure will also be required including: information on the link between pay levels and performance; the important features of remuneration design; the ratio of variable and fixed remuneration; and details of the remuneration of senior management and other executives with the potential to have significant influence on the institution's risk profile. That information is forwarded to the EBA for publication on an aggregate home Member State basis in a common reporting format.

Shareholder powers

11. The Enterprise and Regulatory Reform Act 2013 amended the Companies Act 2006 to incorporate new requirements regarding the remuneration of Directors of all quoted companies. These measures mean:

- the directors' remuneration report must separately include a policy on future director remuneration and payments for loss of office;
- the directors' remuneration policy requires shareholder approval (which is binding) by ordinary resolution at least every three years, or sooner if the policy has changed or if shareholders did not approve the advisory vote on the non-policy part of the directors' remuneration report at the company's previous AGM;
- the company is prohibited from making a remuneration or loss of office payment to a current, former or future director, unless it is consistent with the most recently approved remuneration policy, without a separate shareholder resolution; and

¹⁹⁸³Remuneration principles for banks, building societies and investment firms, Remuneration Principle 12(d), www.fshandbook.info

- a statement of loss of office payments to directors must be published.¹⁹⁸⁴

Shareholders continue to have an annual advisory vote on how remuneration policy has been implemented in the previous year, under the terms of the Directors' Remuneration Report Regulations 2002.¹⁹⁸⁵

Tax policy

12. As well as regulatory interventions, tax policy has been used to address pay in banking. At the December 2009 Pre-Budget report, the then Chancellor of the Exchequer announced that “a temporary bank payroll tax of 50 per cent will apply to discretionary bonuses above £25,000 awarded in the period from Pre-Budget Report [9 December 2009] to 5 April 2010 for each individual employee.”¹⁹⁸⁶ In June 2010 the Government announced that it would introduce a levy on a bank's balance sheets to ensure banks made “a fair contribution in respect of the potential risks they pose to the UK financial system and wider economy.”¹⁹⁸⁷ This was also indirectly targeted at reducing remuneration.¹⁹⁸⁸

13. We identify in Chapter 8 the issue that some senior bankers may build up large pension entitlements, which provide substantial income and may dilute the deterrent effect of clawing back bonus entitlements. Since April 2007, Annual and Lifetime limits on contributions to pensions which receive favourable tax treatment have applied. In December 2012 it was announced that these would be reduced to £1.25m and £40,000 respectively from 2014/15.¹⁹⁸⁹

1984Enterprise and Regulatory Reform Act 2013

1985Directors' Remuneration Report Regulations 2002 (SI 2002/1986)

1986HM Treasury, *Pre-Budget Report*, December 2009, Cm 7747

1987HM Treasury, *Budget 2010*, HC 61, June 2010

1988 *Ibid.* Para 1.99

1989HM Revenue and Customs, Pensions: Restriction of pensions tax relief, Overview Note, www.hmrc.gov.uk

Formal Minutes

Wednesday 12 June 2013

Members present:

Mr Andrew Tyrie MP, in the Chair

Rt Hon Lord Archbishop of Canterbury
Mark Garnier MP
Baroness Kramer
Rt Hon Lord Lawson of Blaby
Mr Andrew Love MP

Rt Hon Lord McFall of Alcluith
Rt Hon Pat McFadden MP
John Thurso MP
Lord Turnbull KCB CVO

Draft Report (*Changing banking for good*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 1209 read and agreed to.

Annexes and Summary agreed to.

Resolved, That the Report be the First Report of the Commission to each House.

Ordered, That the Chair make the Report to the House of Commons and Lord Lawson of Blaby make the Report to the House of Lords.

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134 of the House of Commons).

Written evidence was ordered to be reported to the House for printing with the Report, together with all written evidence previously reported and ordered to be published by the Commission.

[Adjourned.]

List of witnesses to the Commission

	<i>Page</i>
Wednesday 12 September 2012	
Sir David Walker	Ev 1
Wednesday 17 October 2012	
Paul Volcker	Ev 18
Monday 22 October 2012	
Erkki Liikanen , Chair, High-level Expert Group on structural bank reforms established by the European Commission, Governor of the Bank of Finland and member of the Governing Council of the European Central Bank	Ev 32
Wednesday 24 October 2012	
Sir Donald Cruickshank	Ev 42
Thursday 25 October 2012	
Martin Wheatley , Managing Director, Consumer and Markets Business Unit, Financial Services Authority	Ev 53
Monday 29 October 2012	
Professor John Kay , Visiting Professor of Economics, London School of Economics, and Fellow of St John's College, Oxford	Ev 66
Wednesday 31 October 2012	
Martin Taylor , Chairman of Syngenta and former member of the Independent Commission on Banking	Ev 78

Monday 5 November 2012

Ana Botín, Chief Executive Officer, Santander UK, **Douglas Flint**, Chairman, HSBC, and **Antony Jenkins**, Chief Executive Officer, Barclays Ev 94

Wednesday 7 November 2012

Andy Haldane, Executive Director for Financial Stability, Bank of England Ev 113

Thursday 8 November 2012

Professor Rosa Lastra, Professor in International Finance and Monetary Law, Queen Mary, University of London, **Dorothy Livingston**, Chair, Banking Reform Working Group, Law Society of England and Wales and Consultant, Herbert Smith Freehills LLP, and **Bob Penn**, Partner, Allen & Overy Ev 130

John Grout, Policy and Technical Director, Association of Corporate Treasurers, **Baroness Hogg**, Chair, Financial Reporting Council, and **Jessica Ground**, Fund Manager and Analyst, Schroders Ev 139

Monday 12 November 2012

Sir John Vickers, Former Chairman of the Independent Commission on Banking Ev 146

Tuesday 13 November 2012

Stephen Hester, Group Chief Executive, RBS, **António Horta-Osório**, Group Chief Executive, Lloyds Banking Group, and **Peter Sands**, Group Chief Executive, Standard Chartered Bank Ev 164

Monday 19 November 2012

Andrew Bailey, Managing Director, Prudential Business Unit, Financial Services Authority and **Adair Turner**, Baron Turner of Echinswell, Chairman, Financial Services Authority Ev 181

Wednesday 21 November 2012

Rt Hon George Osborne MP, Chancellor of the Exchequer, **Rt Hon Greg Clark MP**, Financial Secretary to the Treasury, **John Kingman**, Second Permanent Secretary, HM Treasury, **Sophie Dean**, Deputy Director Banking Reform Bill Team, HM Treasury Ev 198

Thursday 22 November 2012

Andy Haldane, Executive Director, Financial Stability, Bank of England, **Sir Mervyn King**, Governor, Bank of England and **Paul Tucker**, Deputy Governor, Financial Stability, Bank of England Ev 222

Monday 3 December 2012

Sir James Crosby, former Chief Executive, HBOS, **Andy Hornby**, former Chief Executive, HBOS Ev 242

Tuesday 4 December 2012

Lord Stevenson of Coddham, former Chairman, HBOS Ev 275

Tuesday 8 January 2013

Professor Sir Peter Rubin, Chairman, General Medical Council, **Vernon Soare**, Executive Director, Professional Standards, Institute of Chartered Accountants in England and Wales, and **Antony Townsend**, Chief Executive, Solicitors Regulation Authority Ev 307

Wednesday 9 January 2013

Andrea Orcel, Chief Executive Officer of the Investment Bank, UBS, **Philip Lofts**, Group Chief Risk Officer, UBS, and **Andrew Williams**, Global Head of Compliance, UBS Ev 322

Thursday 10 January 2013 (Morning)

Huw Jenkins, former Investment Bank Chief Executive Officer, UBS, **Jerker Johansson**, former Investment Bank Chief Executive Officer, UBS, **Dr Marcel Rohner**, former Group Chief Executive Officer, UBS, and **Alex Wilmot-Sitwell**, former joint Investment Bank, Chief Executive Officer, UBS Ev 341

Dr Thomas Huertas, former Director, Banking Sector, FSA, **Tracey McDermott**, Director, Enforcement and Financial Crime Division, FSA and **Sir Hector Sants**, former Chief Executive, FSA Ev 361

Thursday 10 January 2013 (Afternoon)

Dr Diane Coyle, Enlightenment Economics, **John Fingleton**, former Chief Executive, Office of Fair Trading, and **Clare Spottiswoode** CBE, former Director General of Ofgas and member of the Independent Commission on Banking Ev 376

Monday 14 January 2013

Gavin Shreeve, Principal, *ifs* School of Finance, and **Simon Thompson**, Chief Executive, Chartered Banker Institute Ev 390

Anthony Browne, Chief Executive, British Bankers' Association Ev 398

Wednesday 16 January 2013

Sir John Vickers, former Chairman, Independent Commission on Banking Ev 411

Thursday 17 January 2013

Professor Julia Black, London School of Economics and Political Science, **Professor David Kershaw**, London School of Economics and Political Science, and **Gregory Mitchell QC**, Three Verulam Buildings Ev 424

Monday 21 January 2013

Dr Adam Posen, Economist and former Monetary Policy Committee member Ev 438

Ken Costa, founder of Ken Costa Strategic and Emeritus Mercers' School Memorial Professor of Commerce, Gresham College Ev 447

Thursday 24 January 2013

Thomas Curry, Comptroller of the Currency, Office of the Comptroller of the Currency, and **Richard Osterman**, Acting General Counsel, Federal Deposit Insurance Corporation Ev 456

Monday 28 January 2013

Martin Taylor, Chairman of Syngenta and former member of the Independent Commission on Banking Ev 474

Giles Andrews, Co-founder and Chief Executive Officer, Zopa, and previous Chair of P2PFA, **Theresa Burton**, Chief Executive Officer and Co-founder of Buzzbnk, **Tony Greenham**, Head of Business and Finance, New Economics Foundation, and **Andrew Robinson**, CCLA Investment Management and Chair of CDF Ev 483

Tuesday 29 January 2013

Tracey McDermott, Director of Enforcement and Financial Crime, Financial Services Authority, and **Graham Nicholson**, Chief Legal Adviser and Adviser to the Governor of the Bank of England Ev 492

Wednesday 30 January 2013 (Morning)

Clive Maxwell, Chief Executive, Office of Fair Trading Ev 506

Gary Hocking, Chief Operating Officer, Payments Council, and **Adrian Kamellard**, Chief Executive, Payments Council Ev 512

Professor Robin Bloomfield, City University London, **Fiona Brownsell**, Director, Tusmor, and **Ben Wilson**, Associate Director, Financial Services Programmes, Intellect Ev 518

Wednesday 30 January 2013 (Afternoon)

Carol Arrowsmith, Vice Chairman and Partner, Deloitte LLP, **David Bolchover**, Management Writer, and **Dr Alexander Pepper**, Professor of Management Practice, London School of Economics and Political Science Ev 525

Alison Carnwath, former Chair of Barclays Board Remuneration Committee Ev 533

Sir John Sunderland, Chair of Barclays Board Remuneration Committee, and **John Thornton**, Chair of HSBC Board Remuneration Committee Ev 537

Paul Sharma, Director, Policy Division, FSA Ev 544

Monday 4 February 2013

Sir Winfried Bischoff, Chairman, Lloyds Banking Group, and **António Horta-Osório**, Group Chief Executive, Lloyds Banking Group Ev 549

Tuesday 5 February 2013 (Morning)

Antony Jenkins, Group Chief Executive, Barclays, and **Sir David Walker**, Chairman, Barclays Ev 568

Tuesday 5 February 2013 (Afternoon)

Bill Winters, former member of the Independent Commission on Banking and former Co-Chief Executive Officer of JP Morgan Investment Bank Ev 591

Sir Brian Pomeroy CBE, former Chairman of the Treasury's Financial Inclusion Taskforce, and **Sian Williams**, Head of Financial Inclusion, Toynbee Hall Ev 602

Wednesday 6 February 2013

Stuart Gulliver, Group Chief Executive, HSBC Holdings, and **Douglas Flint CBE**, Group Chairman, HSBC Holdings Ev 611

Monday 11 February 2013 (Mid Afternoon)

Johnny Cameron, former Chairman of Global Banking and Markets, RBS Group, **John Hourican**, Chief Executive Officer of Markets and International Banking, RBS Group and **Peter Nielsen**, Chief Executive Officer, Markets, RBS Group

Monday 11 February 2013 (Late Afternoon)

Sir Philip Hampton, Chairman, RBS Group and **Stephen Hester**, Chief Executive Officer, RBS Group Ev 645

Thursday 14 February 2013

Eric Daniels, former Chief Executive, Lloyds Banking Group Ev 664

Monday 25 February 2013

Rt Hon George Osborne MP, Chancellor of the Exchequer, and **John Kingman**, Second Permanent Secretary, HM Treasury Ev 678

Wednesday 27 February 2013

Adair Turner, Baron Turner of Ecchinswell, Executive Chairman, Financial Services Authority, and **Martin Wheatley**, Managing Director, Financial Services Authority and Chief Executive Officer Designate of Financial Conduct Authority Ev 695

Wednesday 6 March 2013

Sir Mervyn King GBE, Governor, Bank of England, and **Andrew Bailey**,
Deputy Governor Designate, Bank of England and Chief Executive Officer
Designate, Prudential Regulation Authority

Ev 714

List of written evidence sent to the Commission

	Page	
1	Accord	Ev 736
2	Advisory Board of the Institute of Risk Standards & Qualifications	Ev 1237
3	Affinity Trade Union	Ev 740
4	Association of British Insurers	Ev 742
5	Association of Corporate Treasurers	Ev 1501
6	Association of Financial Markets in Europe	Ev 750
7	Bank of England	Ev 795, 798, 1380, 1499, 1500, 1539, 1606, 1607
8	Barclays	Ev 798, 809, 813, 1502, 1504
9	Bellord, Nicholas J	Ev 815
10	Black, Professor Julia and Professor David Kershaw	Ev 820
11	Board Intelligence	Ev 834
12	Brash, Donald T, former Governor of the Reserve Bank of New Zealand	Ev 837
13	British Bankers' Association	Ev 840, 852, 864, 870, 872, 879, 880, 1504, 1505
14	British Chamber of Commerce	Ev 881
15	British Standards Institute	Ev 883
16	Budd, Sir Alan	Ev 885
17	Budden, Jennifer	Ev 887
18	Building Societies Association	Ev 890
19	Burnley Savings and Loans	Ev 896
20	Bush, Timothy	Ev 899
21	Butler, Cormac	Ev 907
22	Campaign for Community Banking Services	Ev 912
23	Campaign for Regulation of Asset Based Finance	Ev 1508
24	Capie, Forrest	Ev 1511
25	Cassidy, Michael	Ev 1513
26	CBI	Ev 913, 1514
27	Centre for Research on Socio-Cultural Change	Ev 667
28	CFA UK	Ev 919
29	Chadha, Professor Jagjit	Ev 925
30	Chancellor of the Exchequer	Ev 1116
31	Chartered Banker Institute	Ev 926, 1516, 1517
32	Chartered Institute for Personnel and Development	Ev 933
33	Chartered Institute for Securities & Investment	Ev 937
34	Chartered Institute of Internal Auditors	Ev 942
35	Chartered Insurance Institute	Ev 947
36	Christian Council for Monetary Justice	Ev 955
37	Church of England	Ev 956
38	Church of Scotland	Ev 962
39	Citizen's Advice	Ev 965
40	City of London Corporation	Ev 973; 976
41	Clarke, Donald R	Ev 979

42	Crow, Malcolm	Ev 1520
43	Cruickshank, Sir Donald	Ev 981, Ev 982
44	Dalton, Bruce	Ev 1522
45	Dorn, Nicholas	Ev 983
46	Duijsters , J	Ev 989
47	Ecumenical Council for Corporate Responsibility	Ev 992
48	FairPensions	Ev 1003
49	Professor Stella Fearnley and Professor Shyam Sunder	Ev 1633
50	Featherby, James	Ev 1008
51	Federal Deposit Insurance Corporation	Ev 1489
52	FIA European Principal Traders Association	Ev 1011
53	Fidelity Worldwide Investment	Ev 1016
54	Financial Conduct Authority	Ev 1527
55	Financial Ombudsman Service	Ev 1018
56	Financial Reporting Council	Ev 1019
57	Financial Services Authority	Ev 1037, 1045, 1052, 1054, 1055, 1059, 1060,
58		1061, 1063, 1065, 1066, 1249, 1474, 1530, 1532
59	Financial Services Authority and Royal Bank of Scotland	Ev 1068
60	Financial Services Consumer Panel	Ev 1024, 1069
61	Financial Services Practitioner Panel	Ev 1029
62	Foxley, Ian	Ev 1073
63	Fraser, Ian	Ev 1077
64	French, Derek	Ev 1079
65	Global Witness	Ev 1081, Ev 800
66	Goldman Sachs International	Ev 1085
67	Goodhart, Professor Charles A.E.	Ev 1537
68	Greenham, Tony	Ev 1473
69	Harries, C S	Ev 1103
70	Harris , Professor Richard	Ev 1540
71	Hawkins, I	Ev 1104
72	Hermes Equity Ownership Services Ltd	Ev 1109
73	Hill, Geoff	Ev 1112
74	HSBC	Ev 1117
75	Hussey, Simon	Ev 1640
76	ICMA Group Zurich	Ev 1126
77	IFS School of Finance	Ev 1126, 1558
78	Institute of Business Ethics	Ev 1129
79	Institute of Chartered Accountants in England and Wales	Ev 1131, 1560
80	Institute of Operational Risk	Ev 1135
81	Intellect	Ev 1137
82	International Academy of Retail Banking	Ev 1560
83	Investment Management Association	Ev 1155
84	Ipsos MORI	Ev 1163
85	Jeffares, Neil	Ev 1168
86	Jenkins, Huw	Ev 1564
87	Johansson, Jerker	Ev 830
88	Johnson, Dr Timothy	Ev 1172

89	Johnstone, C M	Ev 1182
90	JP Morgan Chase & Co	Ev 1565
91	Kelton, Erika A.	Ev 1185
92	Law Society of England and Wales, and Association of Corporate Treasurers	Ev 1572
93	Law Society of England and Wales	Ev 1189
94	Leadsom MP, Andrea	Ev 1198
95	Legal Services Board	Ev1578
96	Liikanen, Erkki	Ev 1204
97	Lilico, Andrew	Ev 1205
98	Lindsey OBE, Ian W	Ev 1208
99	Lloyds Banking Group	Ev1216, 1226, 1227, 1581
100	London First	Ev 1233
101	Makar, Mira	Ev 1239
102	Mayes, Professor David G , University of Auckland	Ev 1250
103	Mitchell QC, Gregory	Ev 1582
104	Mitchell QC, Iain G.	Ev 1256
105	Moore, Paul	Ev 1588
106	Lord Phillips of Sudbury OBE, Sir John Banham DL,	
107	Tim Melville – Ross CBE, and Sir Stephen O’Brien CBE	Ev 1599
108	NAPF	Ev 1260
109	New Economics Foundation	Ev1473
110	Observatoire Finance Banking	Ev 1263
111	Office of Fair Trading	Ev 1269
112	Office of the Comptroller of the Currency	Ev 1495
113	Oxford Centre for Mutual and Employee-owned Business, Kellogg College, University of Oxford	Ev 1275
114	Payments Council	Ev 1278
115	Personal Finance Education Group	Ev 1280
116	Pope, David	Ev 1282
117	Pringle, Robert	Ev 1286
118	Pro-Housing Alliance	Ev 1294
119	Public Concern at Work	Ev 1299
120	Question of Trust in partnership with Financial Services Research Forum	Ev 1306
121	Reynolds, John	Ev 1309
122	Rippon, Mr	Ev 1312
123	Robertson, James	Ev 1319
124	Rohner, Dr Marcel	Ev 1320, 1321, 1608, 1609
125	Royal Bank of Scotland	Ev 1321
126	Santander	Ev 1326, 1609
127	Sants, Sir Hector	Ev 1333
128	Solicitors Regulation Authority	Ev 1614
129	Spottiswoode, Clare	Ev 1336
130	Stonehaven (Healthcare)	Ev 1337
131	Sturmer, Raymund C.	Ev 1340
132	Taplin, Ian	Ev 1342, 1350
133	TheCityUK	Ev 1364, 1614
134	Theos	Ev 1620

135	TUC	Ev 1367
136	Turner, Nikki and Paul	Ev 1381
137	UBS	Ev 1394, 1624
138	Unite the Union	Ev 1394
139	Universities Superannuation Scheme	Ev 1398
140	Virgin Money	Ev 1417
141	VocaLink	Ev 1439
142	Volcker, Paul	Ev 706
143	Walker, Sir David	Ev 1443
144	Which?	Ev 1443
145	Wilmot-Sitwell, Alex	Ev 1613
146	Woods, Martin	Ev 1626
147	Worshipful Company of International Bankers	Ev 1470

Written evidence published alongside the Commission's First Report

1	Allen & Overy LLP	FR Ev 10
2	Association of British Insurers	FR Ev 16
3	Association of Corporate Treasurers	FR Ev 171
4	Bank of England	FR Ev 180, FR Ev 197
5	Barclays Bank	FR Ev 26
6	British Bankers' Association	FR Ev 35
7	Building Societies Association	FR Ev 41
8	Rt Hon George Osborne MP, Chancellor of the Exchequer	FR Ev 1, FR Ev 191
9	Charity Finance Group, Charities Aid Foundation, the Association of Chief Executives of Voluntary Organisations and the National Council for Voluntary Organisations	FR Ev 43
10	Davis Polk & Wardwell London LLP	FR Ev 46
11	Delegated Powers and Regulatory Reform Committee, House of Lords	FR Ev 53
12	Federation of Small Businesses	FR Ev 188
13	Financial Reporting Council	FR Ev 55
14	Financial Services Authority	FR Ev 57, FR Ev 188
15	Hermes	FR Ev 63
16	HM Treasury	FR Ev 1, FR Ev 173
17	HSBC Holdings	FR Ev 128
18	ICAEW	FR Ev 67
19	Intellect	FR Ev 141
20	Law Society of England and Wales	FR Ev 71
21	Legal & General	FR Ev 145
22	Lloyds Banking Group	FR Ev 84
23	Nationwide Building Society	FR Ev 92
24	new economics foundation	FR Ev 184
25	Nomura	FR Ev 96
26	Prof Rosa Lastra, Queen Mary, University of London	FR Ev 98
27	Royal Bank of Scotland Group	FR Ev 100
28	RBS Pension Trustee	FR Ev 113
29	Santander UK	FR Ev 121
30	Schroders	FR Ev 116

31	Standard Chartered Bank	FR Ev 149
32	TheCityUK	FR Ev 114
33	United Food and Commercial Workers Union	FR Ev 117
34	Vedanta Hedging	FR Ev 189
35	Virgin Money	FR Ev 152
36	Which?	FR Ev 162

Written evidence published alongside the Commission's Third Report

1	Barclays	TR Ev 1
2	Finance Watch	TR Ev 3
3	Financial Services Authority	TR Ev 8
4	HSBC	TR Ev 12
5	Lloyds Banking Group	TR Ev 17
6	Royal Bank of Scotland Group plc	TR Ev 20
7	Standard Chartered Bank	TR Ev 25

Sub-Committee A: Panel on the consumer and SME experience of banks

Witnesses

Witnesses who have given evidence to Sub-Committee A – Panel on the consumer and SME experience of banks are listed below.

Wednesday 26 September 2012

Page

Mike Dailly, Financial Services Consumer Panel, **Christine Farnish**, Chair, Consumer Focus, and **Peter Vicary-Smith**, Chief Executive, Which? A Ev 1

Matthew Fell, Director of Competitive Markets, Confederation of British Industry, **Mike Cherry**, Policy Chairman, Federation of Small Businesses, **Mike Spicer**, Senior Policy Adviser, British Chambers of Commerce, and **Andy Davis**, Finance and Business Writer A Ev 10

Abhishek Sachdev, Vedanta Hedging

Tuesday 16 October 2012

A Ev 19

RBS 1, Strategic Change and Support for Business and Commercial Banking Risk, Royal Bank of Scotland, **RBS 2**, Managing Director of Commercial Banking, RBS, **BARCLAYS 1**, Senior Business Manager, Barclays, **BARCLAYS 2**, Director, Barclays, **LLOYDS 1**, Senior Manager, Lloyds Banking Group, and **LLOYDS 2**, Regional Director, Lloyds Banking Group, A Ev 28

RBS 3, Local Chief Executive Officer, Royal Bank of Scotland, **RBS 4**, Regional Director, RBS, **BARCLAYS 3**, Branch Manager, Barclays, **BARCLAYS 4**, Regional Director, Barclays, **LLOYDS 3**, Branch Manager, Lloyds Banking Group, and **LLOYDS 4**, Regional Director, Lloyds Banking Group A Ev 41

Steve Cooper, Chief Products and Segments Officer, Barclays, **Martin Dodd**, Customer Services Director, Lloyds Banking Group, and **Chris Sullivan**, Head of Corporate Banking Division, Royal Bank of Scotland

A Ev 50

List of published written evidence

1	Barclays	A Ev 65
2	Lloyds Banking Group	A Ev 58
3	Royal Bank of Scotland	A Ev 61

Witnesses

Witnesses who have given evidence to Sub-Committee B – Panel on HBOS are listed below.

	<i>Page</i>
Tuesday 30 October 2012	
Paul Moore , Head of Group Regulatory Risk, 2003– 2004, HBOS	B Ev 1
Colin Matthew , CEO International, 2005– 2008, HBOS	B Ev 12
Jo Dawson , Group Risk Director, 2005– 2006 and Group Executive Director Insurance & Investment Division 2006– 2008, HBOS	B Ev 22
Monday 12 November 2012	
Mike Ellis , Finance Director, 2001– 2004 and 2007–2008, HBOS,	B Ev 31
Phil Hodgkinson , Finance Director, 2005– 2006, HBOS	B Ev 41
Peter Hickman , Group Risk Director, 2007– 2008. HBOS	B Ev 51
Friday 16 November 2012	
Lindsay Mackay , CEO Treasury, 2006– 2008, HBOS	B Ev 60
George Mitchell , CEO Corporate, 2001– 2006 and CEO Treasury, 2004– 2006	B Ev 69
Monday 19 November 2012	
Sir Charles Dunstone , Chair of Retail Risk Committee, 2006– 2008, HBOS	B Ev 83
Sir Ron Garrick , Deputy Chairman, SID and Chair of Corporate Risk Committee, 2006– 2008, HBOS	B Ev 93
Tuesday 20 November 2012	
Anthony Hobson , Chair of Audit Committee, 2001– 2008, HBOS	B Ev 104
Friday 23 November 2012	
Michael Foot , Managing Director, Deposit Takers & Markets Directorate, 1998– 2004, Financial Services Authority,	B Ev 115
David Strachan , Director, Major Retail Groups, 2006– 2008, Financial Services Authority, and Clive Briault , Managing Director, Retail Markets, 2004– 2008 Financial Services Authority	B Ev 123
Tuesday 27 November 2012	
Peter Cummings , CEO Corporate, 2005– 2008, HBOS	B Ev 135

Friday 30 November 2012

Financial Services Authority official

B Ev 157

Witnesses who have given evidence to the main Commission in relation to the inquiry on HBOS are listed below. Transcripts of this oral evidence are available at www.parliament.uk/bankingstandards.

Monday 3 December 2012

Sir James Crosby, CEO, HBOS, 2001– 2006, and **Andy Hornby**, CEO, 2006– 2008 and CEO Retail and Chief Operating Officer, 2001– 2006, HBOS

Tuesday 4 December 2012

Lord Stevenson, Chairman, 2001– 2008, HBOS

List of published written evidence

Written Statements

4	Guy Bainbridge, Auditor, KPMG	B Ev 170
5	Clive Briault, Managing Director, Retail Markets, 2004– 2008, FSA	B Ev 174
6	Sir James Crosby, CEO, 2001– 2006, HBOS	B Ev 180
7	Jo Dawson, Group Risk Director, 2005– 2006 and Group Executive Director Insurance & Investment Division, 2006– 2008, HBOS	B Ev 186
8	Sir Charles Dunstone, Chair of Retail Risk Committee, 2006– 2008, HBOS	B Ev 197
9	Mike Ellis, Finance Director, 2001– 2004 and 2007– 2008, HBOS	B Ev 200
10	Michael Foot, Managing Director, Deposit Takers & Markets Directorate, 1998– 2004, FSA	B Ev 207
11	Sir Ron Garrick, Deputy Chairman, SID and Chair of Corporate Risk Committee, 2006– 2008, HBOS	B Ev 210
12	Peter Hickman, Group Risk Director, 2007– 2008, HBOS	B Ev 217
13	Anthony Hobson, Chair of Audit Committee, 2001– 2008, HBOS	B Ev 223
14	Phil Hodgkinson, Finance Director, 2005– 2006, HBOS	B Ev 227
15	Paul Moore, Head of Group Regulatory Risk, 2003–2004, HBOS	B Ev 251
16	Andy Hornby, CEO, 2006– 2008 and CEO Retail and Chief Operating Officer, 2001– 2006, HBOS	B Ev 233
17	Lindsay Mackay, CEO Treasury, 2006– 2008, HBOS	B Ev 239
18	Colin Matthew, CEO International, 2005– 2008, HBOS	B Ev 244, B Ev 247
19	George Mitchell, CEO Corporate, 2001– 2006 and CEO Treasury, 2004– 2006, HBOS	B Ev 249
20	Richard Powell, formerly of the Bank of England	B Ev 252
21	Lord Stevenson, Chairman, 2001– 2008, HBOS	B Ev 254, B Ev 257
22	David Strachan, Director, Major Retail Groups, 2006– 2008, FSA	B Ev 265
23	Financial Services Authority official	B Ev 268

HBOS Executive Committee Minutes

24	7 May 2002	B Ev 274
25	20 January 2004	B Ev 279
26	17 May 2005	B Ev 285
27	5 – 6 June 2006 (away-day)	B Ev 292
28	17 October 2006	B Ev 304
29	31 October – 1 November 2006 (away-day)	B Ev 311
30	14 September 2007	B Ev 321
31	18 September 2007	B Ev 323
32	23 October 2007	B Ev 328
33	25 – 26 October 2007 (away-day)	B Ev 332
34	22 April 2008	B Ev 340

HBOS Board Minutes

35	26 November 2002	B Ev 345
36	24 June 2003	B Ev 352

37	28 October 2003	B Ev 356
38	27 January 2004	B Ev 360
39	24 February 2004	B Ev 367
40	23 March 2004	B Ev 375
41	18 May 2004	B Ev 380
42	22 June 2004	B Ev 386
43	27 July 2004	B Ev 392
44	1 March 2005	B Ev 397
45	24 May 2005	B Ev 404
46	25 July 2006	B Ev 409
47	22 May 2007	B Ev 415
48	30 October 2007	B Ev 420
49	1 April 2008	B Ev 425
50	28 May 2008	B Ev 430

Approved corporate facilities

51	Corporate banking advances over £20 million, September 2002	B Ev 437
52	Corporate facilities over £75 million, September 2005	B Ev 442
53	Corporate facilities over £75 million, September 2008	B Ev 446

FSA documentation and regulatory correspondence

54	Letter from the FSA to James Crosby dated 24 December 2002	B Ev 449
55	Letter from James Crosby to the FSA dated 12 March 2003	B Ev 469
56	Letter from the FSA to George Mitchell dated 11 December 2003	B Ev 469
57	Letter from George Mitchell to the FSA dated 9 January 2004	B Ev 471
58	Letter from the FSA to James Crosby dated 13 January 2004	B Ev 475
59	MRDG ARROW Panel minutes 8 December 2004	B Ev 489
60	Letter from the FSA to James Crosby dated 21 December 2004	B Ev 492
61	Letter from the FSA to Andy Hornby dated 29 June 2006	B Ev 514
62	Letter from Lord Stevenson to the FSA dated 26 June 2007	B Ev 525
63	Evaluation of progress against ARROW assessment dated October 2007	B Ev 526
64	Email from Lord Stevenson to Sir Callum McCarthy dated 13 November 2007	B Ev 530
65	Letter from the FSA to Andy Hornby dated 21 December 2007	B Ev 531
66	Letter from Lord Stevenson to Sir Callum McCarthy dated 18 March 2008	B Ev 534
67	Draft letter re. HBOS ARROW risk assessment dated March 2008	B Ev 535
68	Letter from the FSA to Andy Hornby dated 22 April 2008	B Ev 535
69	Letter from Andy Hornby to the FSA dated 1 August 2008	B Ev 557
70	Letter from the FSA to Peter Cummings dated 17 October 2008	B Ev 557
71	Financial Services Authority's Risk Mitigation Programme H2 2008	B Ev 560
72	Peter Cummings, CEO Corporate, HBOS, 2006-2008 representations to the Regulatory Decisions Committee	B Ev 571

The following evidence is available at www.parliament.uk/bankingstandards.

HBOS Group Business Plans and other reports

- 73 Five Year Funding Plan 2003
- 74 Funding the Business Plan 2004 – 2008
- 75 HBOS Group Business Plan 2002 – 2006
- 76 HBOS Group Business Plan 2003 – 2007
- 77 HBOS Group Business Plan 2005 – 2009
- 78 HBOS Group Business Plan 2006 – 2010
- 79 HBOS Group Business Plan 2008 – 2012
- 80 PwC Report on s.166

Sub-Committee C: Panel on Corporate Governance: Board Level

Witnesses

Witnesses who have given evidence to Sub-Committee C – Panel on Corporate Governance: Board Level are listed below.

Tuesday 27 November 2012

Page

Professor Julian Franks, London Business School, **Dr Peter Hahn**, CASS Business School, **Dr Tracy Long**, Boardroom Review, and **Stilpon Nestor**, Nestor Advisors C Ev 1

List of published written evidence

81	Arbuthnot	C Ev 106
82	Barclays	C Ev 37
83	Alison Carnwath, Evercore	C Ev 149
84	Citigroup	C Ev 54
85	Clydesdale	C Ev 107
86	Daiwa Capital Markets Europe Limited	C Ev 77
87	Deutsche Bank	C Ev 83
88	Financial Conduct Authority	C Ev 175
89	Financial Reporting Council	C Ev 143
90	Financial Services Authority	C Ev 166
91	Professor Julian Franks, London Business School	C Ev 138
92	Prudential Regulation Authority	C Ev 175
93	Dr Peter Hahn, CASS Business School	C Ev 136
94	Handelsbanken	C Ev 123
95	HSBC	C Ev 75
96	Stilpon Nestor, Nestor Advisors Limited	C Ev 130
97	PricewaterhouseCoopers	C Ev 151
98	Reputability	C Ev 128
99	Santander UK	C Ev 16
100	Standard Chartered	C Ev 25
101	Tapestry Networks	C Ev 140
102	Martin Taylor, former member, Independent Commission on Banking Standards	C Ev 148
103	Towers Watson	C Ev 169

Sub-Committee D: Panel on Corporate Governance: Below Board Level

Witnesses

Witnesses who have given evidence to Sub-Committee D – Panel on Corporate Governance: Below Board Level are listed below.

Thursday 1 November 2012

Page

Ali Parsa, Chief Executive, Circle Partnership

D Ev 1

Wednesday 14 November 2012

Dr Andrew Hilton, Director, Centre for the Study of Financial Innovation, and **Roger Marshall**, Chair, Institute of Internal Audit Committee on Internal Audit Guidance for Financial Services

D Ev 11

Joris Luyendijk, writer and journalist, *The Guardian*

D Ev 21

Monday 19 November 2012

Andy Charlton, Group Head, Compliance, Standard Chartered, **Tracy Clarke**, Group Head of HR and Communications, **Richard Goulding**, Group Chief Risk Officer, **Mike Rees**, Group Executive Director and CEO Wholesale Banking, and **Julian Wynter**, Group Head, Internal Audit

D Ev 31

Eddie Ahmed, Head of Human Resources, EMEA, Citigroup, **Colin Church**, EMEA Chief Risk Officer, **Darren Jarvis**, Chief Auditor, Citi Markets, **Michael Lavelle**, Head of EMEA Capital Markets Origination, and **Charles Ross-Stewart**, Chief Compliance Officer, EMEA

D Ev 44

Tuesday 27 November 2012

Antonio Simoes, Head of UK Retail Banking, HSBC, **Marc Moses**, Chief Risk Officer, HSBC, **David Shaw**, (Acting) Group Head of Compliance, HSBC, **Paul Lawrence**, Group Head of Internal Audit, HSBC, and **Ann Almeida**, Group Head of HR, HSBC

D Ev 60

Wednesday 28 November 2012

Rich Ricci, Chief Executive, Corporate and Investment Banking, Barclays, **Robert Le Blanc**, Group Chief Risk Officer, Barclays, **Mike Walters**, Group Head of Compliance, Barclays, **Michael Roemer**, Chief Internal Officer, Barclays, and **Michael Aldred**, Reward and Performance Director, Barclays

D Ev 82

Sub-Committee E: Panel on Regulatory Approach

Witnesses

Witnesses who have given evidence to Sub-Committee E – Panel on Regulatory Approach are listed below.

Tuesday 11 December 2012

Page

Michael Cohrs, Member of Financial Policy Committee, Bank of England E Ev 1

Michael Foot, Global Vice Chairman, Promontory Financial Group (UK) Ltd, and **Dr Thomas Huertas**, Partner in the Financial Services Risk Practice, Ernst and Young LLP E Ev 11

Monday 17 December 2012

Carol Sergeant, CBE, former Chief Risk Officer, Lloyds Banking Group (2004–11); former Managing Director, Financial Services Authority (1998–2003) E Ev 21

Christine Downton, Vice Chairman of Pareto Partners and Director at Atlantic Philanthropies USA Inc and Governor Emeritus of London School of Economics and a Member of External Investment Committee of Partners Capital Investment Group LLC E Ev 29

Monday 21 January 2013

Andy Haldane, Executive Director, Financial Stability, Bank of England E Ev 35

List of published written evidence

104 **Christine Downton**, Vice Chairman of Pareto Partners and Director at Atlantic Philanthropies USA Inc and Governor Emeritus of London School of Economics and a Member of External Investment Committee of Partners Capital Investment Group LLC E Ev 43

105 **Andy Haldane**, Executive Director, Financial Stability, Bank of England E Ev 44

Sub-Committee F: Panel on Retail Competition

Witnesses

Witnesses who have given evidence to Sub-Committee F – Panel on Retail Competition are listed below.

Tuesday 13 November 2012

Page

Craig Donaldson, Chief Executive, Metro Bank and **Jayne-Anne Gadhia**, Chief Executive, Virgin Money F Ev 1

F Ev 11

Benny Higgins, Chief Executive, Tesco Bank, and **Phillip Monks**, Chief Executive, Aldermore

Tuesday 4 December 2012

Andrea Leadsom MP

F Ev 21

David Yates, CEO, VocaLink, and **Chris Dunne**, Payment Services Director, VocaLink

F Ev 31

List of published written evidence

106	ABDUL	F Ev 60
107	Abundance	F Ev 46
108	Assetz	F Ev 136
109	Big Society Capital	F Ev 70
110	Bradford Enterprise Fund	F Ev 128
111	The Campaign for Community Banking Services	F Ev 126
112	Casey Campbell and Tamar Joulia-Paris	F Ev 47
113	The Community Development Finance Association	F Ev 98
114	Community Investment Coalition	F Ev 95
115	Crowdbnk	F Ev 91
116	Engaged Investment	F Ev 134
117	Ernst and Young	F Ev 124
118	The Finance Innovation Lab	F Ev 88
119	The Funding Circle	F Ev 68
120	Keystone Law	F Ev 105
121	Lloyds Banking Group	F Ev 40
122	The Payments Council	F Ev 133
123	Peer to Peer Finance Association	F Ev 57

124	Prodigy Finance	F Ev 93
125	RateSetter	F Ev 58, F Ev 115
126	Social Enterprise UK	F Ev 53
127	Tesco Bank	F Ev 138
128	Thincats.com	F Ev 131
129	Trillion Fund	F Ev 97
130	Tusmor	F Ev 73 - 88
131	The UK Sustainable Investment and Finance Association	F Ev 113
132	Vocalink	F Ev 116 - 124
133	Zopa	F Ev 52

Sub-Committee G: Panel on the Operation of Wholesale Markets

Witnesses

Witnesses who have given evidence to Sub-Committee G – Panel on the Operation of Wholesale Markets are listed below.

Monday 22 November 2012

Page

Professor Dave Cliff, Dr Jean-Pierre Zigrand and Professor Oliver Linton FBA, lead experts on Foresight report on computer-based trading in financial markets	G Ev 1
Alexander Justham, CEO, London Stock Exchange plc	G Ev 11

List of published written evidence

134	Association of British Insurers	G Ev 18
135	Association of Corporate Treasurers	G Ev 26
136	John Cridland CBE, The Confederation of British Industry	G Ev 33
137	Financial Services Authority	G Ev 28 - 33
138	Future Industry Association, European Principal Traders Association	G Ev 33
139	HSBC	G Ev 39
140	Investment Management Association	G Ev 40
141	London Stock Exchange	G Ev 38

Sub-Committee H: Panel on Tax, Audit, and Accounting

Witnesses

Witnesses who have given evidence to Sub-Committee H – Panel on Tax, Audit and Accounting are listed below.

Wednesday 16 January 2013

Page

Professor Mike Devereux and **Dr John Vella**, Oxford University Centre for Business Taxation H Ev 1

Professor David Cairns OBE, visiting professor, University of Edinburgh Business School, **Professor Stella Fearnley**, Bournemouth University Business School, and **Professor Prem Sikka**, Centre for Global Accountability, University of Essex H Ev 11

Hans Hoogervorst, Chair, IASB, and **Sue Lloyd**, Senior Director of Technical Activities, IASB H Ev 15

Monday 21 January 2013

Andy Haldane, Executive Director, Financial Stability, Bank of England H Ev 20

Wednesday 23 January 2013

Robert Hodgkinson, Executive Director, Technical, ICAEW, **Ian Menzies-Conacher**, Chairman of the International Taxes Sub-Committee, CIOT, and **Chas Roy-Chowdhury**, Head of Taxation, ACCA H Ev 25

John Cullinane, Managing Partner, Tax Quality and Risk, Deloitte, **Jane McCormick**, UK Head of Tax and member of the Board, KPMG UK, **John Preston**, Global Head of External Relations, Regulation and Policy for Tax, PricewaterhouseCoopers, and **Christopher Price**, Head of Financial Services Tax, Ernst and Young H Ev 34

Mike Ashley, Head of Quality and Risk Management, KPMG Europe, **David Barnes**, Managing Partner—Public Policy, Deloitte, **Tony Clifford**, Partner, Financial Services, Ernst and Young, and **John Hitchins**, Global Chief Accountant, PricewaterhouseCoopers H Ev 37

Thursday 24 January 2013

Richard Carter, Director, Business Environment, Department for Business, Innovation and Skills, **Stephen Haddrill**, Chief Executive Officer, Financial Reporting Council, **Jim Harra**, Director-General, Business Tax, HM Revenue and Customs, **Roger Marshall**, Member of the Financial Reporting Council and Chair of the FRC Accounting Council, **Paul Sharma**, Director of Policy, Financial Services Authority, and **Mike Williams**, Director, Business and International Tax, HM Treasury H Ev 47

Monday 28 January 2013

Witness 1 , former employee in Structured Capital Markets, Barclays, and Witness 2 , former Managing Director, Head of Debt Structuring Group, Bank A	H Ev 57
Sir David Tweedie , President, ICAS	H Ev 65

List of published written evidence

142	Association of Chartered Certified Accountants (ACCA)	H Ev 126
143	Association for Financial Markets in Europe (AFME)	H Ev 331
144	Barclays	H Ev 320
145	BDO LLP	H Ev 325
146	British Bankers Association	H Ev 311
147	Buildings Societies Association	H Ev 298
148	Cormac Butler	H Ev 232, H Ev 337
149	Timothy Bush	H Ev 265
150	Prof David Cairns	H Ev 194
151	Chartered Financial Analyst Society UK (CFA UK)	H Ev 280
152	Corporate Reporting Users' Forum (CRUF)	H Ev 309
153	David Damant	H Ev 259
154	Deloitte	H Ev 94
155	Prof Michael Devereux and Dr John Vella, Oxford University Centre for Business Taxation	H Ev 160
156	Ernst and Young	H Ev 177
157	Prof Stella Fearnley, Bournemouth University Business School	H Ev 80, H Ev 231
158	Financial Reporting Council (FRC)	H Ev 136, H Ev 220
159	Financial Services Authority (FSA)	H Ev 134, H Ev 211
160	HM Revenue and Customs	H Ev 166, H Ev 249
161	HM Treasury	H Ev 166, H Ev 247
162	Hermes	H Ev 306
163	HSBC	H Ev 286
164	Institute of Chartered Accountants in England and Wales (ICAEW)	H Ev 90
165	Institute of Chartered Accountants of Scotland (ICAS)	H Ev 73
166	International Accounting Standards Board (IASB)	H Ev 130
167	International Monetary Fund (IMF)	H Ev 256
168	KPMG	H Ev 109
169	Local Authority Pension Fund Forum, including Mr George Bompas QC's legal opinion on International Financial Reporting Standards	H Ev 233
170	Lloyds Banking Group	H Ev 302
171	Mazars	H Ev 262, H Ev 340
172	Organisation of Economic Cooperation and Development (OECD)	H Ev 336
173	Prof Michael Power, London School of Economics	H Ev 229
174	PricewaterhouseCoopers	H Ev 119, H Ev 220
175	Tax Research UK	H Ev 270
176	UK Shareholders Association	H Ev 317

177	Prof Prem Sikka, Centre for Global Accountability, Essex Business School, University of Essex	H Ev 144, H Ev 209
178	Prof Shyam Sunder, Yale School of Management	H Ev 80
179	Universities Superannuation Scheme (USS)	H Ev 294
180	Martin White	H Ev 201
181	Witness 2	H Ev 222

Sub-Committee I: Panel on Scotland

Witnesses

Witnesses who have given evidence to Sub-Committee I – Panel on Scotland are listed below.

Monday 3 December 2012

Page

David Richardson, Development Manager for Highlands and Islands, Federation of Small Businesses, **Colin Borland**, Head of External Affairs, Scotland, Federation of Small Businesses, **Jeff Foot**, Head of External Funding and Investment, Highlands and Islands Enterprise, and **Stewart Nicol**, Chief Executive, Inverness Chamber of Commerce I Ev 1

Ronnie MacRae, Chief Executive, Highlands Small Communities Housing Trust, **Susan Torrance**, Policy Manager, Investment, Asset Management and Development, Scottish Federation of Housing Associations I Ev 9

Friday 7 December 2012

Frank McKillop, Policy and Relations Manager (Scotland), Association of British Credit Unions, and **Gill Mathieson**, Chief Executive, Grampian Credit Union I Ev 15

Yvonne MacDermid, Chief Executive, Money Advice Scotland, **Keith Dryburgh**, Social Policy Officer, Citizens Advice Scotland, **Pauline Allan**, Money Advice Co-ordinator, Citizens Advice Scotland, and **Mike Holmyard**, Money Advice Consultant I Ev 22

List of published written evidence

182	Highlands and Islands Enterprise	I Ev 35
183	The Highlands Small Communities Housing Trust	I Ev 32
184	Scottish Federation of Housing Associations	I Ev 34

Sub-Committee J: Panel on Mis-selling and Cross-selling

Witnesses

Witnesses who have given evidence to Sub-Committee J – Panel on Mis-selling and Cross-selling are listed below.

Wednesday 9 January 2013

Page

Sue Edwards, Head of Consumer Policy, Citizens Advice Bureau, **Peter Vicary-Smith**, Chief Executive, Which?, and **Dominic Lindley**, Principal Policy Adviser, Which? J Ev 1

Angela Knight CBE, former Chief Executive, British Bankers Association J Ev 10

Clive Briault, former Managing Director of Retail Markets, Financial Services Authority J Ev 21

Jon Pain, former Managing Director of Supervision, Financial Services Authority J Ev 32

Peter Davis, former Deputy Chairman, Competition Commission J Ev 38

Thursday 17 January 2013

Stuart Davies, Regional Officer, Unite the Union, **Dominic Hook**, National Officer, Unite the Union, and **Ged Nichols**, General Secretary, Accord Union J Ev 47

Paul Geddes, Chief Executive of Direct Line Group, RBS, 2009-present and CEO of UK Retail Banking, RBS, 2006–09, **Gordon Pell**, Chairman, Retail Banking and Wealth Management, and Chief Executive, Retail Markets, RBS, 2002–07, and **Guy Whittaker**, Group CFO, RBS, 2006–09 j Ev 55

Monday 21 January 2013

Phil Loney, Product Head for General Insurance, Lloyds Banking Group, 2003–10, **Carol Sergeant** CBE, CRO, Lloyds Banking Group, 2004–10, and **Helen Weir**, Principal Retail Distribution, 2008–11 and CFO, 2004–08, Lloyds Banking Group J Ev 84

Thursday 31 January 2013

Natalie Ceeney CBE, Chief Executive and Chief Ombudsman, and **Tony Boorman**, Deputy Chief Executive and Deputy Chief Ombudsman, Financial Ombudsman Service J Ev 114

List of published written evidence

185	Accord	J Ev 292
186	Affinity	J Ev 295
187	Barclays	J Ev 127, J Ev 316
188	Clive Briault, former Managing Director of retail Markets, Financial Services Authority	J Ev 302
189	British Bankers Association (BBA)	J Ev 213
190	Competition Commission	J Ev 244
191	The Co-operative Bank	J Ev 157
192	Financial Ombudsman Service	J Ev 250
193	Financial Services Authority (FSA)	J Ev 256, J Ev 315
194	Angela Knight, former Chief Executive of the British Bankers Association	J Ev 242
195	Lloyds Banking Group	J Ev 180
196	NGSU	J Ev 296
197	Office of Fair Trading	J Ev 266
198	Jon Pain, former Managing Director of Supervision, Financial Services Authority	J Ev 311
199	Royal Bank of Scotland	J Ev 202
200	Santander UK	J Ev 207
201	Unite the Union	J Ev 298
202	Virgin Money	J Ev 209
203	Which?	J Ev 274

Sub-Committee K: Panel on Financial Exclusion and Basic Bank Accounts

Witnesses

Witnesses who have given evidence to Sub-Committee K – Panel on Financial Exclusion and Basic Bank Accounts are listed below.

Friday 1 February 2013

	<i>Page</i>
Sue Edwards , Head of Consumer Policy, Citizens Advice and Nick Waugh , Social Policy Officer, Citizens Advice	K Ev 1
Mike Granville , Head of Stakeholder Relations, Post Office Ltd and Nick Kennett , Financial Services Director, Post Office Ltd	K Ev 8
Anthony Warrington , Director Current Accounts, Lloyds Banking Group and Steve Smith , Retail Competition Strategy Director, Lloyds Banking Group	K Ev 12
Robin Taylor , Head of Banking, The Co-operative Bank	K Ev 20

List of published written evidence

204	Philip Booth, Institute of Economic Affairs and Cass Business School, City University London	K Ev 28
205	Consumer Focus	K Ev 32
206	The Co-operative Bank	K Ev 26
207	Cuna Mutual	K Ev 30