

Financial Services Consumer Panel

**Further Evidence to the Parliamentary
Commission on Banking Standards – Sanctions
for Bank Directors**

January 2013

Summary

The Panel welcomes the opportunity to provide further comment on potential changes to the sanctions regime for directors of failed banks. We have already provided input in this area through our response to the Commission's earlier request for information¹, in the oral evidence given by Panel member Mike Dailly to the Commission on 26 September 2012² and in our response to HM Treasury's consultation paper on Sanctions for Directors of Failed Banks³.

We agree that directors of financial institutions, including banks, should take responsibility for the risks taken as a result of the business' strategy and operations, as well as enjoy financial reward when the business produces profits and growth. The recent history of bank failures has served to emphasise the price paid by customers and taxpayers for directors' bad decisions and those same directors' ability to side step any real individual responsibility for their actions.

Ethical Code

We believe that, as minimum, all banking directors should be required to comply with an Ethical Code for Directors of UK Banks set by a respected professional standards institution, and for such a code to be incorporated in the Code of Practice for Approved Persons (APER) specifically to apply to all directors of UK banks. The Ethical Code should impose robust standards of behaviour and, in particular, address reckless misconduct. We would also see a strong case for applying this more widely to senior executives other than directors.

Criminal sanctions

We strongly support tougher and more effective criminal sanctions for directors of UK banks - and of other financial institutions - in appropriately defined circumstances. In particular, we suggest that primary legislation requires that specific breaches of the proposed Ethical Code give rise to the possibility of criminal sanction, whether as a fine or indeed in the most extreme and serious of cases, a custodial sentence, in order to create a more credible deterrence.

Rebuttable presumption

However, we do not support the introduction of a "rebuttable presumption" which could well have a perverse effect, discouraging the far-sighted and diligent from accepting key management positions.

Use of existing sanctions

We suggest that in addition, regulators should exercise more vigorously the sanctions already available to them to keep individuals without the necessary levels of fitness, propriety and competence from taking up or retaining positions of significant influence within the financial sector.

¹ <http://www.fs-cp.org.uk/publications/pdf/cp-response-parliamentary-commission-on-banking20120924.pdf>

² <http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcb/c619-i/c61901.htm>

³ <http://www.fs-cp.org.uk/publications/pdf/sanctions-consult20120928.pdf>

Questions

1. What are your views on extending criminal sanctions to cover managerial misconduct by bank directors?

The Panel strongly supports tougher and more effective criminal sanctions for directors of UK banks - and of other financial institutions - in appropriately defined circumstances.

We believe that all banking executives should be required to meet an Ethical Code for Directors of UK Banks set by a respected professional standards institution. Such a code should be incorporated in the Code of Practice for Approved Persons (APER) specifically to apply to all directors of UK banks, and arguably to other senior executives. Specific breaches should give rise to the possibility of criminal sanction, whether as a fine or indeed in the most extreme and serious of cases, a custodial sentence.

2. What are your views on the possible formulations of a criminal offence based on options (i) to (iv)?

The Panel's thinking on this has been evolving, and we have considered a number of options. Our philosophy has not changed, rather, our thinking on how best to deliver it has been refined.

Option i), the possibility of a strict liability offence, has been used successfully in non-financial services retail markets for many years and has the benefit of attaching to the point at which the fault lies. More recently the Unfair Commercial Practices Directive – through part 3 of the Consumer Protection from Unfair Trading Regulations 2008 – created a number of strict liability offences. Clearly any new measures would have to incorporate a clear and careful definition of the offence and a short list of 'defences', such as a director joining a bank board after it had failed, to assist with run-down.

In relation to option iv), one possibility could be the establishment of an independent professional body, mandatory membership of which should be debated, with its own civil and possibly criminal prosecution powers based on the concept of recklessness or wilful recklessness.

Another possibility could be a more traditional offence with the two part test of actus reus and mens rea. Under Scottish law, the mens rea test of something done recklessly is sufficient to establish intent at common law, so this would be consistent with both current Scottish practice and one of the early basic principles of English common law.

On balance, however, we believe the best solution to be the Ethical Code incorporated into APER as stated in our answer to question 1.

3. Do you think that an offence based on one of those options would be likely to discourage those considering positions of leadership within banks?

We do not believe that this would be the case, unlike the proposals for a rebuttable presumption that the director of a failed bank is not suitable to be approved by the regulator to hold a position as a senior executive in a bank (see response to q's 7,8 and 9).

4. Will the possibility of criminalising behaviour which can already be sanctioned under Financial Services and Markets Act 2000 (FSMA) act as a greater deterrent?

Criminalisation of specific breaches of a new Ethical Code for bank directors sends a signal as to the seriousness with which certain duties are regarded, as a matter of public policy, and gives the FCA backstop powers.

It may allow the FCA to graduate its enforcement activity, ratcheting up the intensity of intervention, depending on the issue at hand.

There is a need to strengthen the suite of enforcement powers more generally. Private enforcement, for example, is limited in the UK as compared to, for example, private enforcement in the US, where a general anti-fraud rule is used vigorously to proceed against firms. Cross-jurisdictional comparisons should be undertaken with caution, given the range of local factors which shape the compliance and enforcement climate. Nonetheless, there is a need to expand the enforcement 'tool-box' and to send a strong signal as to seriousness of certain core duties.

Criminalisation also sends a very strong signal that 'banks are different' because of the inherent public subsidy. The public interest must be seen, in a very clear way, to trump any potentially conflicting short term shareholder interests. A carefully designed Ethical Code has the potential to capture the fundamental public policy interest at stake, while criminalisation sends a signal as to the importance of that public interest.

5. Do you think that it is likely that the threat of criminal action will stifle perfectly legitimate activity and ultimately deter growth in the banking sector?

No. We believe the potential for criminal sanctions tied to specific breaches of a carefully designed and reasonable Ethical Code would not be a deterrent to legitimate activity. Such sanctions are applied in other sectors such as the legal and accounting professions. All lawyers and accountants complete years of training and examinations before qualifying in which the importance of ethical standards in maintaining trust in the profession is impressed on all trainees. Once qualified, an individual faces significant penalties if they fail to meet the required ethical standards, with the threat of being banned from

practicing or sent to prison highlighting the importance attached to maintaining professionalism in these sectors.

- 6. What are your views on the statement that there appears to be significant reluctance from regulators to take criminal prosecution against banks or individuals responsible for compliance functions? To the extent you agree with the statement, what, in your opinion, are the reasons for this reluctance?**

No comment.

Civil and Regulatory Sanctions

- 7. What are your views on the proposal to introduce a rebuttable presumption that the directors of failed banks are not suitable to hold senior executive positions in other financial institutions?**

and

- 8. Does the rebuttable presumption go any further than the current regulatory regime?**

and

- 9. Do you think that the introduction of the 'rebuttable presumption' could discourage skilled individuals from accepting key management positions?**

We do not support the introduction of a rebuttable presumption which, to the extent that it had traction, could well have a perverse effect, discouraging the far-sighted and diligent from accepting key management positions. The presumption of guilt rather than innocence of directors of failed banks also offends notions of natural justice and due process.

Innocent individuals would face an almost impossible legal hurdle to demonstrate that their actions did not directly contribute to a corporate failure and/or significant detriment. Such an introduction could mean that careful and far-sighted individuals may be deterred from accepting a significant management role, fearing the possibility of a lifetime ban should the bank fail through no fault of their own. By contrast, buccaneering and over-confident individuals who valued instant reward over long-term commitment would be unlikely to be deterred by what they would regard as an improbable set of circumstances and sanction. If it had any effect, a rebuttable presumption could perversely discourage the longsighted and diligent from accepting positions of influence, while failing to weed out the short-sighted risk-seeker: an outcome the precise reverse of that desired. The rebuttable presumption sanction would be of no help to consumers or to anyone else.

10. Do you think introducing the presumption would send a clear message that bank senior executives and boards have a responsibility to ensure there is a strong focus on downside risks?

No, in fact we believe it would have the opposite effect (see answer to 7,8,9 above).

11. What are your views on the possible supporting measures aimed at clarifying management responsibilities and changing the regulatory duties of bank directors?

No comment.

Existing Regulatory Sanctions

12. Despite the range of enforcement powers currently available to the FSA, are additional powers necessary? If so, what would those powers be?

As in our answer to question 4, criminalising a breach of an Ethical Code gives the FCA backstop powers, adding to its 'regulatory toolkit' and allowing a graduated approach to intervention.

In its efforts to deal with behaviour which resulted in the recent financial crisis the FSA, (as Lord Turner noted in his foreword to the FSA report on RBS⁴) was faced with the problem that reckless managerial misconduct by banking directors was not of itself a criminal offence in the UK. Therefore it was very difficult under the current legal regime to 'pin' any one senior banking director down as being responsible in relation to prosecution or individual liability under any other provisions.

The use of an Ethical Code as proposed by the Panel, would mean that, in the event of another crisis, one would only have to prove they were a director subject to the Code and that they had breached that code (using evidence of a systemic banking crisis and insolvency).

13. What are your views on amending FSMA to include a power to prohibit an individual from performing a controlled function on an interim basis?

No comment.

⁴ <http://www.fsa.gov.uk/pubs/other/rbs.pdf>

14. Considering the current powers and measures, do you think the perceived shortcomings in being able to hold individual directors personally culpable are as a result of statutory or regulatory deficits or as a result of regulators and law enforcement agencies not utilising the powers already available to them as fully as they could?

As noted above, Lord Turner, in his foreword to the FSA's report on RBS, stated that 'there is neither in the relevant law nor FSA rules a concept of 'strict liability': the fact that a bank failed does not make its management or Board automatically liable to sanctions. A successful case needs clear evidence of actions by particular people that were incompetent, dishonest or demonstrated a lack of integrity'. An Ethical Code, in conjunction with the APER Code, would address this issue.

However, such a Code must be combined with a willingness to act. In its 2012 Review of the FSA's Conduct Regime⁵, the Panel identified a number of areas where the regulator could have taken action earlier, been more forward looking, or taken action to address the underlying causes of issues. In future, the FCA's action must deter poor conduct behaviour in the firms it regulates. In the last couple of years the FSA has been taking forward more high profile enforcement action, including holding individuals in Significant Influence Functions to account. The Panel applauds this approach and believes the FCA must build on this.

15. What are your views on extending the limitation period for taking action against approved persons?

No comment.

Legislation versus Regulation

16. In order to make bank directors more accountable (due to the adverse impact a large failed bank can have on the wider economy), what are your views on amending the approved persons' regime under FSMA rather than the Companies Act 2006 and the Insolvency Act 1986. To the extent you consider changes should be made to the legal framework, please articulate how you think this could be achieved given the legislation would apply to all company directors.

As outlined above, an Ethical Code for Directors of UK Banks should be written into the Code of Practice for Approved Persons (APER) specifically to apply to all directors of UK banks.

Specific breaches of the proposed Ethical Code should give rise to the possibility of criminal sanction, whether as a fine or indeed in the most extreme and serious of cases, a custodial sentence, in order to create a more credible deterrence. This would require primary legislation.

⁵ <http://www.fs-cp.org.uk/publications/pdf/review-conduct-reg-20120730.pdf>

The Approved Persons' Regime (APER)

17. The Upper Tribunal ruling in *John Pottage v The FSA (FS/2010/0033)* highlighted that enforcement action against senior managers is only likely to be successful where there is evidence of actual wrongdoing by the executive concerned. In your opinion, what changes could be made to some of the statements in APER about the standard of conduct expected of directors in order to make it easier to bring enforcement?

No comment.

18. In your opinion, has a lack of direct senior management accountability inside firms for specific areas of conduct contributed to the shortcomings in holding individuals personally culpable? Do you think APER should be revised to remedy this?

No comment.

19. Would it be beneficial for the regulator to adopt a more intrusive approach to senior appointments as part of the Significant Influence Function (SIF) process? How could such an approach be adopted?

No comment.

20. Do you see merit in requiring the regulator to re-appraise SIF individuals at set intervals and on other occasions if it believes that circumstances justify it.

No comment.

21. What are your views on extending APER so that it applies to all bank employees in order to enable the regulator to take disciplinary action against employees who are currently outside the scope of APER?

and

22. Do you see merit in the establishment of an independent professional body with mandatory membership which has the power to impose civil and possibly criminal sanctions? In your view, could such a body provide a solution for the issue of global matrix management structures that can exist within universal banks?

A mandatory Ethical Code, set by a respected professional standards institution, should apply to bankers who exercise control, leadership or a significant management function within a UK banking institution. The introduction and maintenance of ethical standards will benefit consumers by ensuring banks are being honest and open with them. Customers will have

confidence that a bank will only try to sell a product which truly meets their needs, with any conflicts of interests properly explained so they can make an informed decision. Reward and remuneration structures employed within banks would also be aligned with the best interests of the customer, rather than encouraging product sales at any cost. This will change the dynamic of the UK retail banking industry.

Cost

23. Understandably, there is considerable cost in pursuing individual actions. What changes do you think could be made in order to ensure that cost does not act as a deterrent in pursuing all but the largest cases?

No comment.

International

24. Do you think introducing additional criminal, civil or regulatory sanctions would have an impact on the international competitiveness of UK banks?

No comment.

25. In your opinion, are there other legal or regulatory regimes that the Commission should be considering? Please provide your reasons for suggesting the applicable regime.

No comment.

Other

26. The regulator has an extensive range of enforcement powers but is arguably hesitant in using those powers. What are your views on the introduction of sanction(s) that could be imposed against the regulator to the extent they do not deploy their powers appropriately?

No comment.

27. What are your views on applying different sanctions for different types of directors – for example, non-executive directors?

No comment.

28. Are there any other measures or legal/regulatory changes that the Commission should consider?

The Commission should monitor the progress of EU initiatives on the criminalisation of certain activities, notably with respect to insider dealing and market manipulation. We do, however, caution that enforcement models can differ significantly as between jurisdictions, and reflect different political, cultural, legal and market environments. Care should be taken in undertaking comparisons. We are of the view that a carefully designed Ethical Code, and the related criminalisation of specific breaches, is a proportionate and appropriate mechanism for the UK banking environment.