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Parliamentary Commission on Banking Standards

Changing banking for good

First Report of Session 2013–14

Volume I: Summary, and Conclusions and recommendations

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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.

Current membership

Mr Andrew Tyrie MP (Conservative, Chichester) (Chairman)
Most Rev and Rt Hon the Archbishop of Canterbury (Non-Affiliated)
Mark Garnier MP (Conservative, Wyre Forest)
Baroness Kramer (Liberal Democrat)
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Rt Hon Lord McFall of Alcluith (Labour/Co-operative)
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Lord Turnbull KCB CVO (Crossbench)

Powers

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.

Commission staff

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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 and I

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.

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HC 706-i to -v
HC 821-i to -iii
HC 710-i to -ii
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Summary

Our approach

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

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

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

Making individual responsibility a reality

The problem

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

A new framework for individuals

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

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

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

Incentives for better behaviour

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

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

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

associated with loss of office, to be cancelled in any case in which a bank requires direct taxpayer support.

A new approach to enforcement against individuals

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

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

- all key responsibilities within a bank must be assigned to a specific, senior individual. Even when responsibilities are delegated, or subject to collective decision making, that responsibility will remain with the designated individual;

- the attribution of individual responsibility will, for the first time, provide for the full use of the range of civil powers that regulators already have to sanction individuals. These include fines, restrictions on responsibilities and a ban from the industry;

- the scope of the new licensing regime will ensure that all those who can do serious harm are subject to the full range of civil enforcement powers. This is a broader group than those to whom those powers currently extend;

- in a case of failure leading to successful enforcement action against a firm, there will be a requirement on relevant Senior Persons to demonstrate that they took all reasonable steps to prevent or mitigate the effects of a specified failing. Those unable to do so would face possible individual enforcement action, switching the burden of proof away from the regulators; and

- a criminal offence will be established applying to Senior Persons carrying out their professional responsibilities in a reckless manner, which may carry a prison sentence; following a conviction, the remuneration received by an individual during the period of reckless behaviour should be recoverable through separate civil proceedings.

Reforming governance to reinforce individual responsibility

The financial crisis, and multiple conduct failures, have exposed serious flaws in governance. Potemkin villages were created in firms, giving the appearance of effective control and oversight without the reality. Non-executive directors lacked the capacity or incentives to challenge the executives. Sometimes those executives with the greatest insight into risks being added to balance sheets were cut off from

decision-makers at board level or lacked the necessary status to speak up. Poor governance and controls are illustrated by the rarity of whistle-blowing, either within or beyond the firm, even where, such as in the case of Libor manipulation, prolonged and blatant misconduct has been evident. The Commission makes the following recommendations for improvement:

- individual and direct lines of access and accountability to the board for the heads of the risk, compliance and internal audit functions and much greater levels of protection for their independence;

- personal responsibility for each individual director for the safety and soundness of the firm and a Government consultation on amending the Companies Act to prioritise financial safety over shareholder interests in the case of banks;

- direct personal responsibility on the Chairman to ensure the effective operation of the board, including effective challenge by non-executives, and on the Senior Independent Director, supported by the regulator, to ensure that the Chairman fulfils this role; and

- individual responsibility for a named non-executive director, usually the Chairman, to oversee fair and effective whistle-blowing procedures, and to be held accountable when an individual suffers detriment in consequence of blowing the whistle.

Better functioning markets

The UK banking sector is not as competitive as it should be. Retail and business customers alike are often denied sufficient choice or access to enough information to exercise effective judgement. Greater market discipline can help address the resulting consumer detriment and lapses in standards, and buttress regulation. Where such remedies can be found they should be deployed. The Commission proposes that:

- the Government immediately establish an independent panel of experts to assess means of enabling much greater personal bank account portability;

- the Treasury examine the tax treatment of peer-to-peer lending and crowdfunding firms to ensure a level playing field with established competitors and review the effectiveness of tax incentives intended to encourage investment in Community Development Finance Institutions;

- the major banks come to a voluntary agreement on minimum standards for the provision of basic bank accounts, including access to the payments system and money management services, and free use of the ATM network, within 12 months or be subject to a new statutory duty;

- competition be an objective of the PRA, subject to its overriding responsibility for financial stability;

- the Competition and Markets Authority immediately commence a full market study of competition in the retail and SME banking sectors to be completed on a timetable consistent with a Market Investigation Reference by the end of 2015; and

- the Government should immediately announce a process for considering alternative strategies for the future of RBS, including splitting the bank and putting its bad assets in a separate legal entity (a 'good bank / bad bank' split), to report by September 2013.

Reinforcing the responsibilities of the regulators

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

Our proposed emphasis on individual responsibility within banks needs to be matched by the replacement of mechanical data collection and box ticking by a much greater emphasis on the exercise of judgement by the regulators, supported by more effective oversight and empowerment tools. In particular:

- supervisors need to be close enough, and have a detailed enough understanding, of businesses to take swift decisions based on up-to-date information, rather than belated actions with the benefit of hindsight;

- the most senior regulatory staff should be expected to use judgement, rather than relying on procedures, and to take direct personal responsibility for ensuring that their engagement with individual banks, and the CEO, Chairman and the Board in particular, is securing the information required best to assess risk. They should expect to be held accountable, ultimately to Parliament, for this crucial role;

- a new tool proposed by the Commission, "special measures", will provide for the deployment of a broader range of regulatory powers when the FCA and PRA are concerned that systemic weaknesses of leadership, risk management and control leave a bank particularly prone to standards failures;

- regulators need to remove obstacles to a more competitive market in banking, including through steps to support the development of a more diverse banking market;

- regulators should identify the risks to a judgement-based approach from overly prescriptive international rule books and ensure that Parliament is kept fully informed of them; and

- there should be mandatory dialogue between supervisors and external auditors and a separate set of accounts for regulatory purposes.

The responsibilities of Governments and Parliaments

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

The current Government's particular priorities must include:

- taking swift and decisive action to place RBS in a position where it can make a full contribution to a better functioning market that, in particular, supports lending to businesses;
- ensuring that changes to regulatory objectives entrench a change in regulatory approach towards competition; and
- relinquishing political control over decisions over the leverage ratio, the single most important tool to deliver a safer and more secure banking system, which is properly a matter for regulators.

Future Governments and Parliaments have important roles in ensuring that reform is sustained. In particular, this will mean:

- holding regulators more meaningfully to account for their decisions, while avoiding knee-jerk assumptions either that regulators are acting as an unnecessary constraint on the actions of bankers or that regulators are culpable for every standards failure; and
- resisting the arguments from opponents of reform who will claim that any further change to banking will represent an upheaval too far or that risks have been eliminated and "this time is different".

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

Conclusions and recommendations

Chapter 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. They have failed many retail customers, with widespread product mis-selling. They have failed their own shareholders, by delivering poor long-term returns and destroying shareholder value. They have failed in their basic function to finance economic growth, with businesses unable to obtain the loans that they need at an acceptable price. (Paragraph 1)

2. 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. (Paragraph 6)

3. 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. (Paragraph 7)

4. The UK is a global financial centre, but a medium-sized economy. The benefits of being a global financial centre are very important in terms of jobs, investment, tax revenue and exports. In finance, the UK is a world leader. But being a global financial centre with a medium-sized wider economy also poses risks, as was seen in the bail-outs and huge injections of taxpayers' money which took place during the financial crisis. It is essential that the risks posed by having a large financial centre do not mean that taxpayers or the wider economy are held to ransom. That is why it is right for the UK to take measures, some already taken or in prospect, which not only protect the UK's position as a global financial sector, but also protect the UK public and economy from the associated risks. Much of this Report is about how that should be done. (Paragraph 8)

5. 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. (Paragraph 9)

Chapter 2: The public experience of banks

6. 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. (Paragraph 19)

7. 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. (Paragraph 28)

8. 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. (Paragraph 51)

Chapter 3: The underlying causes

This time is different

9. 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. (Paragraph 66)

10. 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. (Paragraph 67)

Incentives to be unmanageable

11. 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. (Paragraph 74)

12. 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. (Paragraph 86)

13. 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. (Paragraph 93)

14. One of the most dismal features of the banking industry to emerge from our evidence was the striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they presided. Ignorance was offered as the main excuse. It was not always accidental. Those who should have been exercising supervisory or leadership roles benefited from an accountability firewall between themselves and individual misconduct, and demonstrated poor, perhaps deliberately poor, understanding of the front line. Senior executives were aware that they would not be punished for what they could not see and promptly donned the blindfolds. Where they could not claim ignorance, they fell back on the claim that everyone was party to a decision, so that no individual could be held squarely to blame—the Murder on the Orient Express defence. It is imperative that in future senior executives in banks have an incentive to know what is happening on their watch—not an incentive to remain ignorant in case the regulator comes calling. (Paragraph 105)

Paid too much for doing the wrong things

15. 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. (Paragraph 111)

16. 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. (Paragraph 116)

17. 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. (Paragraph 119)

Inadequate checks and balances

18. 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. (Paragraph 130)

19. 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. (Paragraph 135)

20. 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. (Paragraph 143)

Regulation: barking up the wrong tree

21. 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. (Paragraph 158)

22. 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. (Paragraph 167)

23. 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 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. (Paragraph 172)

Incentives to pull in the wrong direction

24. 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. (Paragraph 176)

25. 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. (Paragraph 181)

26. 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. (Paragraph 184)

27. 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. (Paragraph 188)

28. 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. (Paragraph 190)

Insufficient downsides

29. 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. (Paragraph 203)

30. 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. (Paragraph 204)

Chapter 4: Tackling resistance to reform

It's all under control

31. 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. (Paragraph 219)

32. 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. (Paragraph 220)

Risks to the competitiveness of the UK banking sector

33. Banking has been a great British strength, but for that reason is also an important source of risk to Britain. A series of factors, considered below, combine to give the UK an inherent advantage as a place to do financial business. Properly harnessed, finance can greatly add to nationwide prosperity. However, recent history has demonstrated that, whether or not the benefits of a large banking sector have been overstated, the risks were certainly understated. Given the huge size of the banking sector in the UK relative to the overall size of the economy, it is important that policy-makers and regulators balance support for the sector with proper safeguards to limit the potential damage it can do to the UK economy and to taxpayers if things go wrong. The banking collapse of 2008 shows these risks are very real. (Paragraph 224)

34. 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. (Paragraph 232)

35. 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. (Paragraph 237)

36. 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. (Paragraph 247)

37. 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. (Paragraph 255)

38. 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. (Paragraph 261)

Biting the hand that feeds us

39. 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. (Paragraph 270)

40. 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. (Paragraph 271)

Overcoming resistance

41. 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. (Paragraph 272)

42. 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. (Paragraph 273)

Chapter 5: Better functioning markets

A vital utility role

43. 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. (Paragraph 290)

44. 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 development of local and community-based financial platforms should be required for banks to avoid mandatory participation in basic bank accounts. (Paragraph 291)

45. 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. (Paragraph 292)

46. 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. (Paragraph 298)

47. 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. (Paragraph 299)

48. 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. The Commission therefore supports the Government's proposal to legislate if a satisfactory regime is not put in place by voluntary means. (Paragraph 300)

Competition in retail banking

49. 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. (Paragraph 306)

50. 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. (Paragraph 312)

51. 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. (Paragraph 323)

52. 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 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. (Paragraph 327)

53. We welcome the Government's Damascene conversion to bring payments systems under economic regulation and establish a new competition-focused, utility-style 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. (Paragraph 334)

54. 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. (Paragraph 338)

55. 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. (Paragraph 339)

56. 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. (Paragraph 343)

57. 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. (Paragraph 350)

58. 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. (Paragraph 356)

59. 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. (Paragraph 359)

Enabling customer choice

60. 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. (Paragraph 380)

61. 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. (Paragraph 384)

62. 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. (Paragraph 385)

63. 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 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. (Paragraph 386)

64. 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. (Paragraph 387)

A market investigation reference

65. 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. (Paragraph 401)

66. 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 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. (Paragraph 402)

67. 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. (Paragraph 403)

68. 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. (Paragraph 404)

Tackling the information mismatch

69. 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. (Paragraph 416)

70. 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. (Paragraph 423)

Tackling the legacy of RBS

71. 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. (Paragraph 450)

72. 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 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. (Paragraph 451)

73. In considering reprivatisation of RBS, the Government should try to ensure best value for the taxpayer and the wider interests of the UK economy. (Paragraph 460)

74. 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 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. (Paragraph 461)

75. 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. (Paragraph 496)

76. The current strategy for returning RBS to the private sector has been allowed to run for five years. Progress has been made but it is time to look at this afresh. The case has been put to the Commission for splitting RBS into a good bank and bad bank. There may be significant advantages in doing so, including focusing the good bank on UK retail and commercial banking and, by freeing it from legacy problems, strengthening its ability to lend and making it a more attractive investment proposition which could subsequently be privatised at a good price. However, there are also important questions which need to be answered before such a course of action could be recommended. These questions include:

- The cost and risk to the taxpayer;
- 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. (Paragraph 497)

77. 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. (Paragraph 498)

78. 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. (Paragraph 499)

Lloyds Banking Group

79. 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. (Paragraph 511)

Financial literacy

80. 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. (Paragraph 519)

Complaints and redress

81. 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. (Paragraph 523)

82. 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. (Paragraph 529)

83. 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. (Paragraph 530)

84. 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. (Paragraph 532)

Transparency in wholesale and investment banking

85. 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 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. (Paragraph 536)

Chapter 6: A new framework for individuals

What's wrong with the Approved Persons Regime

86. 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. (Paragraph 564)

87. 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. (Paragraph 565)

88. 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. (Paragraph 566)

Making a choice

89. 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. (Paragraph 596)

90. 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. (Paragraph 597)

91. 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. (Paragraph 598)

Milestones for a professional body

92. If a unified professional body for banking in the UK is to emerge, the onus should lie on the industry itself to maintain the impetus for its development. Such a body needs first and foremost to be created through the will, and with the resources, of banks and those who work in the UK banking sector. The Commission's aim in this section is to identify milestones for its development and to assist in fostering its establishment and growth. However, the emergence of a professional body should be consistent with the wider regulatory and legislative reforms needed in banking. It must not be seen as a necessary precursor to those reforms, still less as a substitute for them. (Paragraph 599)

93. 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. (Paragraph 600)

94. 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. (Paragraph 601)

95. 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. (Paragraph 602)

96. 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. (Paragraph 611)

The Senior Persons Regime

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

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

- A Licensing Regime to replace the Approved Persons Regime as the basis for upholding individuals' standards of behaviour, centred on the application of a revised set of Banking Standards Rules to a broader group than those currently covered by the Statement of Principles for Approved Persons; and

- Reform of the register to support the first two pillars and ensure that relevant information on individuals can be captured and used effectively. (Paragraph 612)

98. 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. (Paragraph 616)

99. The Senior Persons Regime should apply to all banks and bank holding companies operating in the UK. The Commission would expect that the Senior Persons Regime would cover a narrower range of individuals than those currently in Significant Influence Functions. Many of the people in these functions are not really senior decision-takers. Taking them out of scope, though still subject to the Licensing Regime that we propose below, would allow the Senior Persons Regime to focus much more clearly on the people who really run banks and who should stand or fall by their role in decision-making. Beyond board and executive committee members, who should always be within scope, primary responsibility for identifying which individuals fall within the regime and how their responsibilities are defined should rest in the first instance with the banks themselves. We would expect such responsibilities to cover both prudential and conduct issues, such as product design. It should not be for the regulator to prescribe how banks structure their management, because it is important that banks retain the flexibility to do this in the most appropriate way for their business. (Paragraph 617)

100. 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. (Paragraph 618)

101. 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. (Paragraph 620)

102. It would be a mistake to prescribe a one-size-fits-all approach to the assessment of fitness and properness to assume a position as a Senior Person. What matters more is that the checks are geared to the responsibilities proposed for the individual and reflect supervisory judgement by senior regulators with involvement in the supervision of the bank concerned, rather than a box-ticking exercise by an isolated unit. The stated intention of regulators to focus more rigorous pre-approval checks on a smaller number of key individuals is to be welcomed. (Paragraph 625)

103. 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. (Paragraph 626)

104. 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. (Paragraph 627)

The Licensing Regime

105. 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. (Paragraph 632)

106. The Commission recommends that the Licensing Regime cover anyone working in banking, including those already within the Senior Persons Regime, whose actions or behaviour could seriously harm the bank, its reputation or its customers. It would not need to cover staff working in auxiliary or purely administrative roles, or those in junior positions whose autonomy and responsibility is very limited. Such a scope is likely to include all staff currently covered by the Approved Persons Regime, including those in customer dealing functions. (Paragraph 633)

107. 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. (Paragraph 634)

108. 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. (Paragraph 640)

109. 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. (Paragraph 641)

110. 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. (Paragraph 642)

111. It should be the job of the bank as employer to inform and instruct each licensed person of his or her responsibilities and to keep accurate records. Individuals within the Licensing Regime who are not Senior Persons can nevertheless have important responsibilities which could have a significant impact on the bank or its customers. The Commission recommends that the regulators have the discretionary power to require those leaving such posts to prepare handover certificates in line with our earlier recommendation in relation to Senior Persons. Banks may want to provide training and support to employees to help them understand how the banking standards rules translate to an individual's specific role, and reflect the rules in their own appraisal processes. Professional standards bodies may be able to play a valuable role in this area. However, the creation and implementation of such a process should not be held by the regulator to be a substitute for compliance with the substance of the standards rules. Most bankers may behave honourably "when no-one is watching", but some will do so only if there is a genuine prospect that someone might in fact come looking. Banks need to maintain and where necessary implement systems that include checks and random audits, rather than simply addressing standards issues with process-driven training or when those issues hit the front pages and threaten the brand. In support of these responsibilities of the firm, we would expect a Senior Person to be directly responsible for the performance by a bank of its licensing responsibilities. (Paragraph 643)

112. 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. (Paragraph 644)

113. 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. (Paragraph 645)

Reforming the register

114. It will be important for the register underpinning the current Approved Persons Regime to be reformed to take account of the Commission's recommendations. A single register should cover both the Senior Persons Regime and the Licensing Regime, although for individuals covered only by the Licensing Regime it is likely to be more proportionate only to include their details where there has been enforcement action against them. Banks should be required to inform regulators if they take disciplinary action against an employee for reasons related to a breach of the banking standards rules. In such cases regulators should assess whether any further sanction is merited. Regulators should be able to retain such information for their own purposes even where they decide not to proceed with enforcement action. The regulators should explore whether information about disciplinary dismissals could also be communicated to prospective employers, although the Commission recognises the potential legal difficulties with such an approach. (Paragraph 651)

115. Sanctions imposing restrictions on practising can only be effective if they cannot be circumvented by moving within the industry. Strengthening the register will address this domestically, but much more should also be done to move to mutual recognition of sanctions between jurisdictions. Of particular benefit would be an obligation on firms to take account of any misdemeanours recorded on the register in other jurisdictions before hiring staff. The need for such an obligation between the US and UK is particularly important. The development of such an obligation, and in particular comprehensive coverage, may take time. It might ultimately require legislative change both here and in the US to be effective. The Commission recommends that the Government and the UK regulators initiate early discussions with US counterparts on this issue. Subsequent discussions with the EU and other financial centres may also be appropriate. (Paragraph 654)

Banking as a special case

116. 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. (Paragraph 656)

Chapter 7: Bank governance, standards and culture

Shareholders: the silent owners

117. 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. (Paragraph 666)

118. 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 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. (Paragraph 674)

Bank boards and governance

119. 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-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. (Paragraph 684)

120. 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. (Paragraph 703)

121. 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. (Paragraph 705)

122. 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. (Paragraph 706)

123. 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. (Paragraph 707)

124. 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. (Paragraph 708)

125. 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. (Paragraph 712)

126. 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. (Paragraph 715)

127. 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 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. (Paragraph 717)

128. 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. (Paragraph 720)

Internal controls and disciplines

129. 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. (Paragraph 729)

130. 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. (Paragraph 735)

131. 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. (Paragraph 736)

132. 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. (Paragraph 737)

133. Internal audit's independence is as important as that of the Chief Risk Officer and the Head of Group Compliance, and its preservation should similarly be the responsibility of a named individual non-executive director, usually the chairman of the audit committee. Dismissal or sanctions against the head of internal audit should also require the agreement of the non-executive directors. (Paragraph 741)

134. 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. (Paragraph 742)

Standards and culture

135. 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. (Paragraph 748)

136. Poor standards in banking are not the consequence of absent or deficient company value statements. Nor are they the result of the inadequate deployment of the latest management jargon to promulgate concepts of shared values. They are, at least in part, a reflection of the flagrant disregard for the numerous sensible codes that already existed. Corporate statements of values can play a useful role in communicating reformist intent and supplementing our more fundamental measures to address problems of standards and culture. But they should not be confused with solutions to those problems. (Paragraph 754)

137. 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. (Paragraph 762)

138. 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. (Paragraph 763)

139. 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. (Paragraph 768)

140. 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. (Paragraph 769)

141. 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. (Paragraph 770)

Driving out fear

142. 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. (Paragraph 784)

143. In addition to procedures for formal whistleblowing, banks must have in place mechanisms for employees to raise concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing. It is in the long-term interest of banks to have mechanisms in place for ensuring that any accumulation of concerns in a particular area is acted on. Accountability for ensuring such safeguards are in place should rest with the non-executive director responsible for whistleblowing. (Paragraph 786)

144. 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. (Paragraph 788)

145. 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. (Paragraph 791)

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

147. 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. (Paragraph 793)

148. 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. (Paragraph 796)

149. 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. (Paragraph 799)

150. 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. (Paragraph 803)

151. 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. (Paragraph 804)

152. 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. (Paragraph 805)

Chapter 8: Remuneration

Rewards out of kilter

153. 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. (Paragraph 836)

154. Aggregate remuneration continues to consume a high share of returns relative to shareholder dividends and capital. From this share, a relatively small proportion of senior management and supposedly irreplaceable key staff have received very large rewards. Banks should be free to compete in the global market: the use of remuneration to retain the most productive staff is a legitimate management tool. However, the financial crisis and its aftermath have exposed the extent to which many of the highest rewards were unjustified. Senior bankers have also benefited from a remuneration consultancy industry whose advice may itself have been distorted by conflicts of interest and by board Remuneration Committees trapped into ever higher awards by allegiance to colleagues and the ratchet effect of industry competitors. A culture of entitlement to high pay developed which has yet fully to be dispelled. (Paragraph 837)

155. 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. (Paragraph 838)

156. 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. (Paragraph 839)

Fixed and variable remuneration

157. 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. (Paragraph 850)

158. 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. (Paragraph 851)

Yardsticks for variable remuneration

159. 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. (Paragraph 861)

160. 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. (Paragraph 862)

161. 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. (Paragraph 863)

162. 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. (Paragraph 864)

Reforming variable remuneration

163. 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. (Paragraph 877)

164. 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. (Paragraph 878)

165. For the most senior and highest rewarded it is even more crucial that their remuneration reflects the higher degree of individual responsibility expected of them. Flexibility on the part of firms, and judgement on the part of regulators, is essential to take account of wide variations of risk and time horizons of its maturity in different areas of banking. Poorly designed schemes may increase the risk of gaming or circumvention of regulations and will have adverse or perverse affects on behaviour. (Paragraph 879)

166. 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. (Paragraph 880)

167. 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. (Paragraph 881)

168. 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. (Paragraph 882)

169. 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. (Paragraph 883)

170. One of the fundamental weaknesses of bank remuneration in recent years has been that it lacked down-side incentives in the worst case scenarios that were remotely comparable to the upside incentives when things seemed to be going well. This disparity was laid bare by taxpayers bailing out failed banks while those responsible for failure continued to enjoy the fruits of their excess. We believe that the alignment of the financial interests of the most crucial bank staff with those of the bank is an important factor in addressing this imbalance. The Commission recommends accordingly that legislation be introduced to provide that, in the event that a bank is in receipt of direct taxpayer support in the form of new capital provision or new equity support, or a guarantee resulting in a contingent liability being placed on to the public sector balance sheet, the regulators should have an explicit discretionary power to render void or cancel all deferred compensation, all entitlements for payments for loss of office or change of control and all unvested pension rights in respect of Senior Persons and other licensed staff. (Paragraph 884)

171. 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. (Paragraph 885)

172. 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. (Paragraph 886)

Board remuneration

173. 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. (Paragraph 890)

The international dimension

174. Remuneration requirements should, ideally, be mandated internationally in order to reduce arbitrage. The Commission expects the UK authorities to strive to secure international agreement on changes which are focused on the deferral, conditionality and form of variable remuneration, and the measures for its determination, rather than simply the quantitative relationship to fixed remuneration, because it is changes of this kind that will most improve the behaviour of bankers in the longer term. In particular, we expect the Government and the Bank of England to ensure that the technical standards under 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. (Paragraph 896)

175. It must be recognised, however, that international agreement on some of the changes we envisage may be neither fast not complete. This may lead some to advance the

argument that the UK will be placed at a competitive disadvantage. The extent to which this is true has been overstated. The UK has great strengths as a financial centre, but, partly because of those strengths, it also faces substantial risks. The PRA must adopt a common sense and flexible approach to handling these issues. However, its overriding objective of financial stability should not be compromised and, in fulfilling this objective, the risk of an exodus should be disregarded. (Paragraph 897)

Getting it done

176. 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. (Paragraph 899)

177. 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. (Paragraph 900)

178. 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. (Paragraph 905)

179. 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. (Paragraph 906)

180. 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. (Paragraph 908)

Chapter 9: Regulatory and supervisory approach

Regulatory failure

181. 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. (Paragraph 931)

182. 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. (Paragraph 932)

Real-time supervision

183. 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, 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. (Paragraph 941)

184. 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. (Paragraph 942)

185. 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 excessive data collection would need to be supported by evidence. It is not enough to complain only in private. (Paragraph 946)

186. 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. (Paragraph 953)

187. 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. (Paragraph 954)

188. 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. (Paragraph 957)

Supervisor relationship with banks

189. 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. (Paragraph 965)

Special measures

190. 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. (Paragraph 970)

191. As part of the continuing dialogue between the PRA and the FCA at the most senior levels within the two organisations, and through their risk assessment frameworks, we expect the two regulators to consider cases which might require the deployment of the tool we propose, which can be termed 'special measures'. Special measures will take the form of a formal commitment by the bank to address concerns identified by the regulator. Ahead of placing a bank in special measures, we consider that the regulators should commission an independent report to examine the extent to which their initial source of concern may be an indicator of wider conduct or standards failings. It will be important for such reports to be truly independent. We consider it inappropriate therefore for a bank's auditors, or those who might compete to

become the firm's auditors in the near future, to be appointed to carry out this task. There would be an expectation that reports would be prepared quickly. (Paragraph 971)

192. Where the report reveals problems requiring rectification or there remains cause for regulatory concern, the Commission recommends that the regulators have a power to enter into a formal commitment letter with the bank concerned to secure rectification measures and to provide a basis for monitoring progress in addressing the concerns. The Commission recommends that a bank in special measures be subject to intensive and frequent monitoring by the regulators. An individual within the bank should be made responsible for ensuring that the remedial measures are implemented to the regulators' satisfaction. As part of this process, the regulators might wish to require the retention of an independent person to oversee the process from within the bank. 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. (Paragraph 972)

193. 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. (Paragraph 973)

Supervisory resources

194. 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. (Paragraph 982)

195. 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. 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. (Paragraph 985)

A role for senior bankers?

196. 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. (Paragraph 991)

Regulatory framework

197. 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. (Paragraph 997)

198. 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. (Paragraph 998)

199. 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. (Paragraph 1002)

200. The Commission is disappointed at the Government's negative response to our recommendation in our First Report that the FPC be given responsibility for setting the leverage ratio. We have two major concerns. First, we consider that the 3 per cent minimum leverage ratio is too low. Second, we see no good reason for the Government's proposal to delay a review of the FPC's proposed power to determine leverage ratios until 2017. We note that the Chancellor's explanation regarding the Government's rejection of a higher leverage ratio relied on allegedly 'compelling' representations to the Treasury that a higher ratio would cause unintended damage; the Commission is not persuaded. If problems are created for banks with particular characteristics, they should be addressed by specific derogations not by reducing the leverage ratio for all banks. (Paragraph 1011)

201. 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. (Paragraph 1012)

202. 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. (Paragraph 1013)

Aligning tax rules with regulatory objectives

203. 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. (Paragraph 1018)

204. 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 for the regulated banking sector alongside an uplift in the Bank Levy to offset the cost to the Exchequer in full. (Paragraph 1026)

Accounting for regulatory needs

205. 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. (Paragraph 1030)

206. 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. (Paragraph 1033)

207. 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. (Paragraph 1039)

Clearer auditors' reports

208. 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. (Paragraph 1042)

It's good to talk

209. 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. (Paragraph 1047)

210. 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. (Paragraph 1053)

The new regulatory structure and our approach

211. 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. (Paragraph 1064)

Regulatory objectives

212. 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. (Paragraph 1069)

213. 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 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. (Paragraph 1074)

214. 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. (Paragraph 1078)

Regulatory accountability

215. 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. (Paragraph 1079)

216. 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. (Paragraph 1093)

217. 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. (Paragraph 1103)

218. 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 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. (Paragraph 1104)

219. 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. (Paragraph 1105)

220. 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. (Paragraph 1106)

221. 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. (Paragraph 1107)

222. 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. (Paragraph 1108)

The new responsibilities

223. 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. (Paragraph 1110)

Physician, heal thyself

224. 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. (Paragraph 1111)

225. 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. (Paragraph 1112)

226. 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. (Paragraph 1113)

Warnings from history

227. 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. (Paragraph 1115)

Chapter 10: Sanctions and enforcement

Enforcement against banks

228. Effective enforcement action against firms represents an important pillar of the overall approach to enforcement. In many cases, it serves as the gateway to enforcement action against responsible individuals, which is also necessary. It can draw wider attention to a failure, providing incentives for firms to strive to maintain high standards, and establishes penalties when banks depart from those standards. The record of the regulators in enforcement against firms is patchy at best. It is notable that both significant prudential failures, for example at RBS, and some widespread conduct failures in the selling of PPI did not lead to successful enforcement against banks. In the investigations those at the top often absolved themselves by attesting their ignorance about the organisation of which they were in charge. It would run contrary to the public interest if the idea were to gain currency that banks can be too big or complex to sanction. (Paragraph 1129)

229. 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. (Paragraph 1130)

230. 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. (Paragraph 1131)

231. 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. (Paragraph 1132)

232. In its Report on LIBOR, the Treasury Committee concluded that "the FSA and its successors should consider greater flexibility in fine levels, levying much heavier penalties on firms which fail fully to cooperate with them". We agree. Cooperation by firms in bringing issues to regulators' attention and assisting with their investigation should be a given. Regulators should make full use of the flexibility in their penalty policy to punish cases where this does not occur. However, regulators should also make it clear to firms that the same flexibility will be used to show leniency where inadvertent and minor breaches are swiftly brought to their attention and rectified, so that the fear of over-reaction does not to stifle the free flow of information. (Paragraph 1133)

233. 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. (Paragraph 1134)

Civil sanctions and powers of enforcement over individuals

234. 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. (Paragraph 1165)

235. 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. (Paragraph 1166)

236. The foundations for a new approach are laid in the Commission's recommendations in Chapter 6. In that chapter we recommended that a successor to the Statement of Principles in the form of Banking Standards Rules designed to ensure that the full range of enforcement tools could be applied to a wider range of individuals working in banking. This would be supported by a system of licensing administered by individual banks, under the supervision of the regulators, to ensure that all those subject to the Banking Standards Rules were aware of their obligations. This approach would prevent one barrier to effective enforcement that we identified, namely that regulators lacked effective powers to sanction misconduct by bankers who were not Approved Persons. (Paragraph 1167)

237. 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. (Paragraph 1168)

238. 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. (Paragraph 1169)

239. 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. (Paragraph 1170)

240. 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. (Paragraph 1171)

241. 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. (Paragraph 1172)

242. 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. (Paragraph 1173)

A new criminal offence?

243. 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. (Paragraph 1182)

244. 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. (Paragraph 1183)

245. 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. (Paragraph 1184)

246. 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. (Paragraph 1185)

Enforcement decision-making

247. There is an inherent tension between the role of real-time regulators and the enforcement function, which can involve reaching judgements about matters in which supervisors were involved at the time. Regulators are also focused on the big picture, such as maintaining financial stability. Greater priority needs to be placed on the role of enforcement, with adequate resources devoted to this function and leadership with a willingness to pursue even the difficult cases, often involving the larger and more powerful players, in order to build up a credible deterrent effect. (Paragraph 1199)

248. 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. (Paragraph 1200)

249. 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. (Paragraph 1201)

250. 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. (Paragraph 1202)

Chapter 11: The way forward

251. 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. (Paragraph 1205)

252. 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. (Paragraph 1206)

253. 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. (Paragraph 1208)

254. 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. (Paragraph 1209)