HM Treasury

Department
for Business
Innovation & Skills

The Government's response to the Parliamentary Commission on Banking Standards

Cm 8661

July 2013

The Government's response to the Parliamentary Commission on Banking Standards

Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

July 2013

Cm 8661 £21.25

© Crown copyright 2013

You may re-use this information (excluding logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit www.nationalarchives.gov.uk/doc/open-government-licence/ or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

Any enquiries regarding this publication should be sent to us at public.enquiries@hm-treasury.gov.uk.

You can download this publication from www.gov.uk

ISBN 978-0-10-186612-5
PU1502

Printed in the UK by the Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office

Printed on paper containing 75% recycled fibre content minimum

ID 2572391 07/13

Contents

		Page
Foreword		3
Chapter 1	Introduction	5
Chapter 2	Strengthening individual accountability	9
Chapter 3	Reforming corporate governance	21
Chapter 4	Securing better outcomes for consumers through enhanced competition	29
Chapter 5	Enhancing financial stability	35
Chapter 6	Implementation of the Commission's recommendations	47
Annex A	The Commission's recommendations	49
Annex B	Government response to the Commission's second report	73
Annex C	Government response to the Commission's third report	75
Annex D	Summary of consultation responses to sanctions for the directors of failed banks	77

Foreword

The Parliamentary Commission for Banking Standards' final report, *Changing banking for good*, is a huge achievement and its analysis and recommendations build on a formidable evidence base. We would like to thank Andrew Tyrie and his Commission for their time, diligence and expert input.

The report makes clear that banks in the UK have not done enough to carry out their core role of financing economic growth. Many of them have also failed taxpayers, their customers and their shareholders. Trust in banking is at a low ebb.

The Commission's report is the third stage in the Government's programme to reform this flawed financial system we inherited.

First, we have fundamentally reformed the previous, failed, tripartite system of financial services regulation, through the Financial Services Act 2012. We established the Financial Policy Committee, as a strong and expert macro-prudential authority within the Bank of England; created the Prudential Regulation Authority as a subsidiary of the Bank of England; and set up a new independent conduct of business regulator, the Financial Conduct Authority.

Second, we are restructuring the banking system to address the problems posed by banks that are perceived as "too big to fail". The Banking Reform Bill, which is currently before Parliament implements the recommendations of the Independent Commission on Banking; including introducing a ring-fence around banks' deposits to separate important everyday banking activities from investment banking activities.

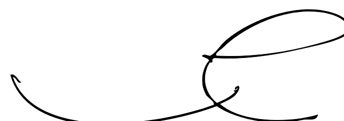
Third, following the emergence of LIBOR and other banking scandals last year, the Government set up the Wheatley Review, and in response to its recommendations, brought the setting of LIBOR under the scope of regulation and made misleading statements in relation to LIBOR a criminal offence. We then supported Parliament in setting up the Parliamentary Commission on Banking Standards to address the wider problems that these scandals highlighted, focusing on professional scandals, culture and corporate governance.

The behaviour of some in the financial services industry has damaged the reputation of an industry that employs hundreds of thousands of people and is vital to our economic prosperity. We today set out plans to implement the major recommendations of *Changing banking for good* including:

- our plans to review the case for an RBS "bad bank";
- a new banking standards regime governing the conduct of bank staff;
- the introduction of a criminal offence for reckless misconduct by senior bank staff; and
- taking further steps to improve competition in the banking sector.

The implementation of the Government's response to *Changing banking for good* will enhance the soundness and stability of the banking sector, and comprehensively address the problems with standards which have done so much to undermine society's faith in the banking system.

George Osborne,
Chancellor of the Exchequer



Vince Cable,
Secretary of State for Business,
Innovation and Skills

1 Introduction

1.1 On19 June 2013, the Parliamentary Commission on Banking Standards ("the Commission") published its final report, *Changing banking for good*.[1] This is a landmark report that will have a profound impact in raising standards across the banking industry. The Government strongly endorses the principal findings of the report and intends to implement its main recommendations.

1.2 In this response to the Commission's report, the Government is setting out its initial views on the major recommendations of the report. The Government indicates where it can move quickly to implement recommendations and which of those recommendations require further detailed work to ensure effective implementation. On those few recommendations where the Government disagrees with the Commission, the Government sets out its reasoning and explains how it intends to achieve the goals of the Commission through other means.

Background

1.3 The LIBOR manipulation scandal and the Payment Protection Insurance (PPI) and interest rate swap mis-selling scandals showed that alongside a widespread failure of competence in the banking industry, there was a failure of professionalism and ethics. Following the emergence of these scandals, the Government announced the creation of the Parliamentary Commission on Banking Standards under Andrew Tyrie MP, chair of the Treasury Select Committee.

1.4 The Commission's terms of reference were 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.

Report conclusions and recommendations

1.5 The Commission's final report sets out a compelling case for change and makes over 100 recommendations, which fall under four broad themes:

- **strengthening individual accountability**: The Commission notes that too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. The report makes important recommendations around sanctions, standards and remuneration in order to strengthen accountability and incentives for bankers to behave ethically and in a way that supports the long-term sustainability of banks.

[1] *Changing banking for good*, Report of the Parliamentary Commission on Banking Standards, First Report of Session 2013-14, June 2013 – all volumes available at: http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/

- **reforming corporate governance**: The report notes that weaknesses in corporate governance both at board level and below contributed to a lack of effective control and oversight of risks within banks, and suggests a package of recommendations to remedy these defects, including around resourcing for non executives and provisions to strengthen the role of chief risk officer, internal audit, and compliance functions.

- **securing better outcomes for consumers through enhanced competition**: The Commission highlights the vital role that a well-functioning, competitive market for banking services will play in limiting consumer detriment and poor standards. It sets out a number of positive interventions to support competitive pressures within the sector, including around enabling consumers to move more easily between different banks to access products and services that best meet their needs.

- **enhancing financial stability**: The Commission makes a number of recommendations aimed at supporting financial stability at systemic and institutional level. These include recommendations on the approach to the taxpayer's stakes in the Royal Bank of Scotland (RBS) and Lloyds banking Group (Lloyds), which the Government supports. It also makes a number of more detailed recommendations about the objectives and organisation of the new regulatory bodies.

1.6 The Government is very grateful for the work of the Commission. The Government agrees with the overall conclusions of the Commission and accepts all of its principal recommendations. Specifically, the Government is announcing today that it is planning to implement the following major recommendations of the report:

- Strengthening individual accountability by:
  - introducing a tough new Senior Persons regime governing the behaviour of senior bank staff;
  - introducing new banking standards rules to promote higher standards for all bank staff;
  - introducing a new criminal offence for reckless misconduct for senior bankers;
  - reversing the burden of proof so that bank bosses are held accountable for breaches within their areas of responsibility; and
  - working with the regulators to implement the Commission's proposals on pay. This will allow bonuses to deferred for up to 10 years and enable 100 per cent clawback of bonuses where banks receive state aid.
- Asking the regulators to implement the Commission's key recommendations on corporate governance to ensure that firms have the correct systems in place to identify risks and maintain standards on ethics and culture.
- Supporting competition in the banking sector by:
  - providing the Prudential Regulation Authority (PRA) with a secondary competition objective to strengthen its role in ensuring banking markets are effective and deliver good outcomes for consumers; and
  - asking the new payments regulator, once established, to urgently examine account portability and payments system ownership.

1.7 As already announced by the Chancellor of the Exchequer on 19 June 2013, HM Treasury has launched a review of the case for establishing a "bad bank" consisting of some high risk RBS

assets. The Office of Fair Trading (OFT) has brought forward its review of competition in the small and medium enterprise (SME) sector.

1.8 In response to the Commission's other recommendations, the Government has initiated detailed further work to explore the best path for their implementation.

1.9 The rest of this document sets out the Government's initial response to the Commission's overall conclusions and its response to all of its key detailed recommendations. The Bank of England, the PRA and the Financial Conduct Authority (FCA) will be issuing their own responses in the autumn. A full list of the Commission's recommendations is set out at Annex A.

1.10 The Commission's recommendations are also set out in bold type in the body of the text of this response document, along with the paragraph number of where the recommendation can be found in volume II of the Commission's report.[2]

1.11 The other annexes to this document:

- respond to earlier reports from the Commission: its second report, *Banking reform: towards the right structure*, published on 11 March 2013[3] (Annex B) and its third report on *proprietary trading*, published on 15 March 2013[4] (Annex C); and
- set out a summary of responses to the Government's 2012 consultation on *sanctions for the directors of failed banks*[5] (Annex D).

1.12 On 5 April 2013, the Commission published a report on the collapse of Halifax Bank of Scotland (HBOS), *An accident waiting to happen: The failure of HBOS,*[6] which informs the recommendations in their final report. The Government welcomes the work the Commission has done to shed light on the factors that contributed to HBOS's failure and the subsequent need for government intervention. The report identifies a number of specific themes on which the regulators are requested to expand. These themes will be addressed by the PRA and the FCA as part of a report on the failure of HBOS, which they expect to publish later this year.

[2] *Changing banking for good*, Report of the Parliamentary Commission on Banking Standards, Volume II Chapters 1-11 and Annexes, together with formal minutes, June 2013 – http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/

[3] *Banking reform: towards the right structure*, The Parliamentary Commission on Banking Standards, Second Report of Session 2012-2013, March 2012 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/126/126.pdf

[4] *Propriety Trading*, Parliamentary Commission on Banking Standards, Third Report of Session 2012-2013, March 2013 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/138/138.pdf

[5] *Sanctions for the directors of failed banks*, HM Treasury, July 2012 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81565/consult_sanctions_directors_banks.pdf

[6] *An accident waiting to happen: the failure of HBOS*, The Parliamentary Commission on Banking Standards, Fourth Report of Session 2012-2013, April 2012 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/144.pdf

2 Strengthening individual accountability

2.1 The Commission's report emphasises the need to strengthen accountability and incentives for bankers to behave ethically and in a way that supports the long-term sustainability of banks. The Commission argue that the current regime – the Approved Persons Regime – has failed to set clear expectations for individuals, in particular senior individuals, performing key roles in banks. It has also failed to hold senior managers to account for the failures that took place within banks that were brought to light during, and in the aftermath of, the financial crisis.

2.2 The Government agrees with the Commission's analysis. Low standards of conduct and managerial performance, particularly in relation to risk management, were important contributing factors to the financial crisis. The crisis highlighted the important role that individuals, especially directors and senior managers, play in the key decisions taken by banks – decisions which can have far-reaching consequences not just for the institution concerned or its customers but for government, taxpayers and the wider economy. At the same time, the financial crisis exposed the difficulties faced in holding senior management in banks and other financial institutions to account for these decisions.

2.3 The Commission highlighted the role that inappropriate remuneration structures have played in encouraging excessive risk taking. The Commission has also raised the link between inappropriate remuneration structures for retail staff, and the incentives for this category of staff to engage in inappropriate conduct, such as mis-selling. The Commission has put forward proposals to further improve the alignment of pay incentives with risk and conduct, and the Government broadly endorses its approach.

Setting and enforcing standards for individual conduct

Progress to date

A regulator focused on the conduct of business and addressing the attempted manipulation of the London Interbank Offered Rate (LIBOR)

2.4 The Government has already taken decisive action through the Financial Services Act 2012 to strengthen individual accountability by setting up a focused conduct of business regulator in the Financial Conduct Authority (FCA), with a judgement-led regulatory approach to deal with conduct issues in both an effective and proportionate manner. Further details are set out in chapter 5.

2.5 The Government also took swift action to address the attempted manipulation of the London Interbank Offered Rate LIBOR when it came to light last year. It established a review under Martin Wheatley,[1] and implemented its key recommendations of bringing benchmark activities within the scope of statutory regulation under Financial Services Markets Act 2000 (FSMA) and creating a new, distinct criminal offence for making false or misleading submissions in connection with the determination of benchmarks. The Government also continues to work closely with the European and international community to drive forward work on the long-term

[1] *The Wheatley Review of LIBOR*, final report, September 2012 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf

future of LIBOR and issues relating to other global benchmarks. One of the Wheatley Review's principal recommendations was for the British Bankers Association (BBA) to transfer responsibility for LIBOR to a new administrator. An independent committee chaired by Baroness Hogg is currently running the tender process to recommend the new administrator. The committee expects to make its recommendation in the summer.

2.6 The financial crisis also brought to light the lack of an effective means of imposing sanctions on key individuals responsible for failures in financial institutions under the existing regulatory framework. This was made clear, for example, in the Financial Services Authority's (FSA) detailed report into the failure of the Royal Bank of Scotland (RBS)[2] and its assessment of whether any of the individuals managing RBS could be subject to regulatory sanction under existing powers set out in FSMA.

Government consultation on sanctions for the directors of failed banks

2.7 The Government issued a consultation document on *Sanctions for the directors of failed banks* in July 2012.[3] The consultation considered proposals for:

- legislating to amend FSMA in order to put in place a "rebuttable presumption" that a director of a failed bank is not suitable to be approved by the regulator as someone who could hold a position as a senior executive in a bank; and
- the introduction of criminal sanctions for serious misconduct in the management of a bank including a strict liability offence, offences for negligence, incompetence or recklessness.

2.8 The consultation closed on 30 September 2012. The non-confidential responses to the consultation are summarised in Annex D.

2.9 Following this consultation, and at the request of the Chancellor of the Exchequer, the Commission considered and reported on options for regulating standards of conduct of individuals working in banking and financial services, and on ensuring there are adequate arrangements for imposing sanctions on individuals responsible for misconduct.

Taking forward the Commission's recommendations

A new regime for regulating individual standards in banking

2.10 The Commission's report is very critical of the FSMA Approved Persons Regime, which is currently the primary framework for regulatory engagement with individual bankers. In particular, the Commission is concerned that the regime operates largely as an initial gateway to the industry and does not set expectations for those performing key roles in banks. The Commission is also critical of the pace of change within the existing FSMA framework and took the view that a new regulatory framework for individuals is needed.

2.11 The Government accepts the conclusion that the current Approved Persons Regime has failed and will work with the FCA and the Prudential Regulation Authority (PRA) to create a new framework for regulating individual standards of conduct in banking based on strengthening individual accountability. The Government will ensure that the new framework includes all the important safeguards in current legislation which ensure that the interests of consumers and the

[2] *The failure of the Royal Bank of Scotland*, Financial Services Authority Board Report, December 2011 – http://www.fsa.gov.uk/pubs/other/rbs.pdf

[3] *Sanctions for the directors of failed banks*, HM Treasury, July 2012 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81565/consult_sanctions_directors_banks.pdf

integrity of financial markets are protected. These changes will be made through amendments to the Banking Reform Bill, currently before Parliament.

2.12 While the Commission's recommendations relate to standards in the banking sector, they consider it plausible that the weaknesses of the Approved Persons Regime affect not just the banking sector but other parts of the financial services industry too. The Government agrees with this and notes that many of the failures identified by the Commission were not limited to the banking sector. The Commission propose that, **to avoid delay to banking reforms, the Commission's recommendations should initially be put in place for banking only** (656).[4] In fact, because the relevant FSMA provisions apply to all parts of the financial services industry, it would be simpler legislatively and operationally to apply any reforms to the framework for regulating individuals to the financial services industry as a whole. The Government will therefore consider with the regulators whether to amend the relevant FSMA provisions to allow for wider application of the proposed reforms.

Senior Persons Regime

2.13 As recommended by the Commission, **the Government will introduce a new Senior Persons Regime, to replace the Approved Persons Regime** (612, 616, 617, 620, 626) as it applies to persons with responsibility within the firm for managing the business and the key risks that the firm faces. As with the current regime, firms would be required to seek the regulator's approval before appointing a person to a post which includes functions covered by the Senior Persons Regime.

2.14 The Government agrees that it is important to ensure that those who run banks are fully accountable for their actions. To that end, the Government will introduce new criminal sanctions for reckless misconduct by senior bank staff (see below). **The Government will also take forward a number of detailed recommendations made by the Commission to ensure accountability under the new Senior Persons Regime** (1170, 1173). **These include:**

- **"reversing the burden of proof"** to ensure that Senior Persons can be held to account for contraventions of regulatory requirements in their areas of responsibility unless they can demonstrate that they took all reasonable steps to prevent the contravention occurring or continuing in the part of the business for which they have responsibility;
- **extending the time limit** for commencing disciplinary action against Senior Persons; and
- giving regulators the power to make **approvals of Senior Persons subject to conditions or time limits.**

2.15 The design of these provisions will require detailed consideration to ensure that the new regime is fair and effective.

2.16 In line with the recommendations of the Commission, **the Government will not take forward the introduction of the "rebuttable presumption"** (1170) that was considered in the July 2012 consultation. The Government accepts the Commission's view that the "rebuttable presumption" could be a blunt instrument and agrees that the measure to reverse the burden of proof would be more effective in ensuring accountability by Senior Persons for contraventions in their area of responsibility.

[4] Numbers in brackets reflect the paragraph number where the recommendation appears in the Commission's final report.

Criminal sanctions for managerial misconduct

2.17 As the Prime Minister indicated on 19 June 2013, **the Government accepts the Commission's recommendation on introducing criminal sanctions for reckless misconduct in the management of a bank** (1182, 1183), and will continue to work on developing a suitable offence that is compliant with the European Convention on Human Rights (ECHR), with a view to including appropriate amendments to the Banking Reform Bill in the autumn. This will hold Senior Persons to account and will be a helpful deterrent against misconduct which can result in severe economic disruption and considerable losses for taxpayers. The Government agrees with the Commission that only individuals who are performing the functions of a Senior Person should be criminally liable for this offence. The Government will consider further how it is possible to implement the Commission's recommendation relating to the **recovery of remuneration obtained as a consequence of reckless misconduct** (1184).It will also consider whether to **introduce a time limit for initiating proceedings for the offence** (1185).

Banking standards and other employees ("licensing regime")

2.18 **The Government will also take forward the Commission's recommendation to replace the existing statements of principle (and codes of practice) for Approved Persons with banking standards rules** (634), which will also apply to employees who are not subject to prior regulatory approval. This will ensure that enforceable standards of conduct will apply to all persons whose actions could seriously harm a firm, its reputation or its customers. With that in mind, the Government will also ensure that these rules can be tailored appropriately to the functions performed and the types of business carried out.

2.19 The Government will ensure that **regulators have the ability to take disciplinary action against individuals who are not Senior Persons or subject to prior regulatory approval when they have breached the new banking standards rules or are knowingly concerned in a breach of regulatory requirements** (632, 633). **The regulators will be able to deploy the full range of civil sanctions against Senior Persons and other employees who are guilty of misconduct** (1171). The extended time limit for taking disciplinary action against Senior Persons will also apply for disciplinary action against other individuals. However, the Government does not propose to reverse the burden of proof in disciplinary cases against persons who are not subject to the Senior Persons Regime as it would not be appropriate to do so in cases against persons who do not have senior management responsibilities.

2.20 The Government agrees with the Commission that there could be advantages in increasing transparency by including details of individuals' misconduct in other jurisdictions in the UK register. It will take forward with the regulators the Commission's recommendation to **initiate discussions with counterparts in other jurisdictions about exchanging information about misconduct published in national registers of financial services employees** (651, 654). The Government will also ask the regulators to consider whether there would be benefits in including more information in the publicly available registers.

Promoting higher professional standards

2.21 The Commission supports **the creation of a professional body funded by the industry to promote higher professional standards in banking which might over time demonstrate that it could be given a more formal role** (596, 599, 601, 763). The Government welcomes this recommendation and trusts that industry will show the commitment and initiative to take it forward. No legislation is required at this stage and the Government will not be including any amendments on this subject in the Banking Reform Bill.

Remuneration

2.22 The actions of individual bankers are influenced not only by the regulatory and enforcement framework in which they work, but also by the incentives that their reward packages create. At the root of the financial crisis was the development of fundamentally improper risk appetites within financial institutions, driven by inappropriate incentive structures for individual bankers. There is widespread agreement that poorly designed remuneration structures incentivised excessive risk taking in the lead up to the financial crisis.

2.23 Alongside the need to align pay with appropriate risk appetite is the need to ensure that where an individual has demonstrated behaviour that falls below the robust ethical and professional standards expected of them, a considerable proportion of their remuneration package can be clawed back. It is also important to consider how inappropriate remuneration structures for retail staff can incentivise inappropriate behaviours for this category of staff.

Progress to date

2.24 In the aftermath of the financial crisis, it was agreed that globally aligned action was needed to curb remuneration practices which encouraged excessive risk taking. In 2009, G20 leaders endorsed the Financial Stability Board (FSB)[5] Principles and Standards for Sound Compensation Practices. These global standards set out clear principles on pay structures for senior staff and material risk takers, whereby:

- a substantial proportion of compensation should be variable and paid on the basis of performance;
- 40 to 60 per cent of variable remuneration should be payable under deferral arrangements over a period of at least three to five years; and
- that these proportions should increase significantly according to the level of seniority and responsibility of an individual.

2.25 The FSB Principles also included tough rules on transparency, including disclosure of senior staff pay and its composition aggregated in bands. It also proposed further reforms to governance, including the selection and evaluation processes for bankers, increases to directors' time commitment and financial services expertise and an ability for national supervisors to limit distributions of variable compensation where they are inconsistent with the maintenance of a sound capital base.

2.26 All G20 countries, including the US and European Union (EU) Member States, committed to implement these Principles. The UK was one of the first to do so, before there were common European rules in this area, through the FSA's Remuneration Code 2009. The Remuneration Code was updated in 2010 to reflect the EU Capital Requirements Directive (CRD3) which was the European application of the FSB Principles. A new Remuneration Code came into force on 1 January 2011. The PRA ensures that bonus and dividend distribution plans are consistent with required capital levels so that banks can rebuild capital, which in turn allows them to increase lending to households and businesses.

2.27 The recent bonus round indicated that these policies are having a significant effect on bonuses, continuing the trend from previous years: bonus pools at almost all major UK banks

[5] The FSB was established in 2009 to coordinate the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.

declined during the 2012-13 bonus round, with an even more significant decline when compared to 2010-11. For example, the bonus pool at RBS's investment bank is almost 70 per cent lower than in 2010-11, and at Barclays Capital almost 40 per cent lower than in 2010-11.

2.28 Taken together, these reforms place the UK at the leading edge of international practice on responsible remuneration in the banking sector.

Box 2.A: Remuneration and the Capital Requirements Directive (CRD4)

Remuneration continues to be considered at a European level. The latest revision of the Capital Requirements Directive (CRD4) includes a new principle for a cap on the amount of bonus that can be paid relative to fixed pay. This would mean that bonuses would be limited to no more than 100 per cent of fixed pay, unless a shareholder vote increases this to a limit of 200 per cent.

These amendments to CRD4 were introduced without any impact assessment or underpinning evidence. The Government has raised concerns that this may lead to increases in fixed pay if banks decided to maintain the same overall pay levels, and also risk discouraging use of deferral. Fixed pay cannot be clawed back in the case of malpractice by individuals, and is not performance related. If a bank were to face difficulties, it would also mean that banks could not reduce remuneration quickly in order to conserve capital, as fixed pay is harder to cut.

As such, the Government insisted that European rules should further encourage banks to pay bonuses in long-term deferred remuneration and strengthen clawback provisions. EU rules in this area now enable firms to pay 25 per cent of total variable remuneration in long-term instruments, by discounting their value for the purpose of the bonus cap.

The Government considers it imperative not to undermine the significant progress which has been made in requiring banks to align remuneration with risk, particularly following the UK's strict application of the previous CRD3.

Taking forward the Commission's recommendations

2.29 The Commission has looked at pay incentives in detail and made a number of recommendations aimed at:

- further strengthening the alignment of pay with the long-term health of banks, and with sound ethical business practices;
- building on the action taken to address the implicit taxpayer guarantee on large banks by putting deferred pay at risk in the event of a bail-out; and
- improving pay transparency.

2.30 The Government supports the conclusions of the Commission on remuneration and broadly accepts its specific recommendations. There is more work required to define the detailed application of these recommendations in a number of areas as laid out below.

Scope of application

2.31 International and domestic reforms on remuneration to date have focussed on individuals who pose the greatest risk to the stability of an institution. These individuals have been designated as Material Risk Takers, and comprise any employee whose actions may have a material impact on the risk profile of an institution, regardless of seniority.

2.32 The Commission recommends that **the remuneration proposals apply to all individuals whose actions or behaviour could seriously harm the bank, its reputation, or its customers** (900). In addition, 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** (899).

2.33 The recommendation to apply the remuneration proposals to staff that could seriously harm the bank, its reputation, or its customers would extend the application of remuneration restrictions from Material Risk Takers (including Senior Persons) to appropriate regulated staff, in accordance with proposals on replacing the Approved Persons Regime. However, the Government considers that the prescriptive rules on remuneration regarding structure and deferral, which are designed to reduce excessive risk-taking and reinforce financial stability, are only appropriate for individuals whose actions may have a material impact on the risk profile of a firm, i.e. Material Risk Takers defined in accordance with European Banking Authority (EBA) rules.

2.34 The remuneration principles applying to Material Risk Takers were agreed at the international level through the FSB Principles and are in place to ensure financial stability. Applying these rules to all regulated staff would therefore go significantly beyond existing international standards, introducing inconsistency in the regulation of remuneration, and could strictly regulate the pay of junior staff whose actions do not have a material impact on the risk profile of an institution.

2.35 In order to address potential misalignment of incentives for the appropriate category of regulated staff, the FCA is currently undertaking a thematic review of the impact of sales-based incentives on retail staff using its existing powers. The FCA will consider **the Commission proposals on sales-based incentives** (864) as part of this review. The Government looks forward to the FCA report on this and will update on progress in the autumn.

2.36 In terms of the proposal for a statutory Remuneration Code, the Government considers that the remuneration proposals which the Commission has put forward can be accommodated under the existing framework or existing rule-making powers. It is not clear that it is necessary to change the statutory basis for the Remuneration Code (which is issued under powers given to the regulators in FSMA) to achieve the Commission's objectives.

2.37 Therefore, the Government proposes that the reforms recommended by the Commission should be implemented for the Senior Persons at UK authorised banks through the existing powers given to the regulators under FSMA. The Government recognises that other regulated staff can also affect the reputation and customers of a bank, as suggested by the Commission, and that poorly designed remuneration packages may contribute to that. Alongside legislation to introduce the new banking standards regime, the Government will also ask the regulators to consider the case for extending high-level principles on remuneration to all UK regulated staff.

Structure of remuneration

2.38 As a result of the introduction of the Remuneration Code, there has been a significant shift in the way bankers are paid. The Remuneration Code requires at least 60 per cent of bonuses for high earners to be deferred, with at least 50 per cent to be paid in shares or capital instruments, and places a clear limit on cash bonuses. This has led to a substantial reduction in upfront cash bonuses which can encourage or exacerbate short-term risk taking to the detriment of the long-term health of the institution. The Code has improved the alignment of individual pay with the risks taken by, and performance of, the institution by requiring individuals to take most of their bonus in shares and long-term instruments which they must hold for a period of time after the award has been made.

2.39 The Commission recommends that **executive staff to whom the Code applies receive variable remuneration with a significant proportion in deferred form and deferred for longer**. The form of this deferred remuneration should include **greater use of instruments such as "bail-in bonds"**, and the Commission further suggests that regulators should have the power **to require a substantial part of remuneration be deferred for up to 10 years, where it is necessary for effective long-term risk management** (878, 880, 881).

2.40 The Government strongly supports these proposals and remains committed to ensuring that pay decisions at financial institutions are taken in accordance with the long-term best interests of the firm. The introduction of regulatory deferral periods for remuneration awards has played an important role in restructuring pay and reducing incentives to take excessive risk and therefore supporting prudential soundness. Extended deferral periods can help to further improve the alignment of individual and institutional incentives by ensuring a longer period during which variable pay can be subject to the application of malus.[6] The Remuneration Code encourages a long-term approach to decision-making on pay by requiring that a significant proportion of the variable remuneration of risk takers is deferred for a minimum of three to five years, and subject to an appropriate retention period upon vesting. This is in keeping with the Commission's approach, and ensures that the financial incentives for individuals are more closely aligned to the long-term performance of the institution.

2.41 However, as the Commission has recognised, no single deferral period is appropriate, and firms should retain the flexibility to set deferral periods in accordance with the business cycle, the nature of the business, its risks and the activities of the employee in question. The regulators already have the power, subject to EU law, to require that a substantial part of remuneration should be deferred for longer periods where they judge that this is necessary or expedient to advance any of their objectives. At the same time, the Government notes that the bonus cap provisions in CRD4 risk discouraging the use of deferral provisions by encouraging higher upfront fixed salaries. The Government will ask the PRA to consider the way in which this discretion is applied as part of its consultation on implementing the Commission proposals.

2.42 In terms of the instruments which comprise deferred remuneration, while the use of equity has a legitimate role to play in aligning incentives, the Government has also indicated its support for pay awards in long-term instruments such as "bail-in bonds" under new regulatory proposals. As part of European negotiations on CRD4, the Government argued that rules capping the ratio of fixed-to-variable pay should encourage banks to pay bonuses in long-term deferred remuneration by giving such instruments preferential treatment under the cap. The Government also insisted that the definition of variable pay should allow for payment in instruments aligned with the long-term health of banks such as "bail-in debt", ensuring that individuals who take risks also bear the cost should an institution face financial difficulty.

Recouping deferred remuneration

2.43 The ability to reduce or recover variable pay in light of misconduct is important for managing risk, and for strengthening personal accountability. The mechanism for such pay recovery usually operates through the application of malus or clawback.[7] The Remuneration Code requires firms to have a performance adjustment (malus) policy in place to reduce or revoke pay where subsequent information on poor performance comes to light, which reduces incentives to engage in misconduct and ensures the accountability of individuals.

[6] Malus allows a bank to prevent the rights to all or part of a deferred bonus vesting with an individual.

[7] Clawback refers to a contractual agreement whereby an individual agrees to return ownership of vested remuneration to an institution under certain circumstances.

2.44 The Government expects a proactive approach to the application of these policies where there is evidence of misconduct, such as the misreporting of LIBOR, and its EU equivalent the Euro Interbank Offered Rate (EURIBOR) and the mis-selling of Payment Protection Insurance (PPI). There has been progress during the recent 2012-13 bonus round in this regard. For example, at RBS, the £300 million LIBOR/EURIBOR fine was recovered from the incentives pool for 2012-2014, with £112 million clawed back from previous unvested deferred bonus awards. At Barclays PLC, there was an £860 million reduction in the 2012 incentives pool to account for misconduct, with £300 million clawed back from previous unvested deferred bonus awards.

2.45 However, the Commission rightly highlights that **deferred remuneration should be seen as contingent, so that it can be recouped in a wider range of circumstances** (882). The Government agrees with this approach, notwithstanding the progress made on recovering remuneration following recent conduct failures. The examples in the Remuneration Code highlighting instances in which remuneration can be recovered is not intended to be exhaustive, and firms should consider the application of malus or clawback in a wider set of circumstances.

2.46 The Commission suggests **that the PRA examines whether there is merit in further powers…to recover remuneration received or awarded in the period to which the enforcement action applied** (883). The Government agrees that the accountability of individuals for long tail misconduct risks should not be removed upon the vesting of remuneration, and clawback should play a greater role in complementing the application of malus. However, as the Commission has noted, there are legal and practical obstacles to clawback and limits on when it can be applied. The Government will therefore ask the PRA to consider appropriate ways in which to strengthen clawback, as part of its implementation of the Commission's proposals.

Provision in the event of taxpayer bailout

2.47 The Commission has also considered recouping remuneration in extraordinary circumstances. The Commission proposes that the Government introduces legislation to provide **that, in the event of state aid, regulators have an explicit discretionary power to render void or cancel all deferred compensation, all entitlements for payments for loss of office or change of control and all unvested pension rights in respect of Senior Persons and other regulated staff** (884).

2.48 The Government agrees that there should be specific powers available for the regulator in relation to remuneration at banks in the event of the bank requiring state assistance. The ability to reduce or revoke deferred remuneration when a bank requires state aid would further strengthen accountability, and complement the extensive reforms which the Government has undertaken to remove the implicit taxpayer guarantee. The reforms introduced under CRD4 have reinforced existing rules on pay at banks in receipt of state support, requiring that: bonuses are strictly limited where inconsistent with the maintenance of a sound capital base and timely exit from Government support; regulators will be able to require banks to restructure remuneration in a way aligned with sound risk management and long-term growth; and directors should not receive a bonus unless justified.

2.49 The Government will seek to build on these reforms by asking the PRA to consider the scope to reduce or revoke deferred compensation, unvested pension benefits, loss of office payments where a bank requires certain forms of state support, the population to which these rules should apply and whether further powers are desirable in this regard.

Board remuneration

2.50 The Commission recommends that **variable, performance-related remuneration be prohibited for non-executive directors (NEDs) of banks** (890). The Government agrees that NEDs serve a different function from other members of the board, by challenging decision-making without being influenced by the rewards of improved financial performance in the short-term.

However, it is not clear why the NEDs of a bank should be treated differently to those employed at wider listed companies. The UK Corporate Governance Code already requires that "remuneration for non-executive directors should not include share options or other performance-related elements". The Government will ask the PRA to consider if further action is needed in relation to the specific proposal by the Commission.

Provisions for change of employment

2.51 A change to employment circumstances can, in certain circumstances, limit the accountability of an individual for misconduct which may have occurred at a previous employer. This arises when individuals forfeit deferred remuneration owed to them by an employer upon taking up employment at another bank. The new employer then compensates the individual to the value of remuneration forfeited ("buy-out"), but the ability to apply malus or clawback by the previous employer is removed.

2.52 The Commission therefore suggests that the **regulator consider the need for new rules on this issue, which may include a discretionary power to recover from a new employer the amount of deferred remuneration that would have been deducted from an employee guilty of misconduct, but could not be recovered because that individual switched employer and forfeited previously deferred remuneration** (885).

2.53 The remuneration rules agreed under CRD4 have elevated the status of existing PRA guidance on this matter to a formal requirement. This requires that the "buy-out" should align with the long-term interests on the institution and be subject to appropriate retention and performance adjustment arrangements, which includes deferral and clawback. This remains the basis of the PRA supervisory approach. However, these rules do not specify whether the application of malus/clawback to buy-out awards should cover performance or misconduct at the previous employer. The Government will therefore ask the PRA to consult on this issue as part of its implementation of the Commission's proposals.

Disclosure and transparency

2.54 The Government has been clear that shareholders should play an active role as stewards of companies in which they invest, and is committed to ensuring they have greater information to scrutinise pay decisions. The UK has been a global leader in improving remuneration disclosure, putting in place the most comprehensive measures of any major financial centre and pressing for further minimum standards across Europe. For example, through the negotiation and implementation of CRD3 aggregate remuneration disclosure requirements, proposing and leading in the development of individual anonymised pay disclosures for executives below board level, and through disclosing the level and structure of pay of Material Risk Takers. These changes represent the most comprehensive shareholder oversight of pay of any major jurisdiction.

2.55 The Commission proposes **a range of additional disclosures, including: the range of metrics and risk factors taken into account when determining pay awards; differences between expected and realised remuneration awards; a summary of the methodology underlying pay decisions; and realised remuneration by business line** (863).

2.56 The Government believes that any further reforms should build on existing improvements to transparency, and provide shareholders with the information needed to enhance market discipline. The Government is already legislating to simplify pay reporting for directors, and has legislated to provide shareholders with the tools to use this information effectively and hold boards to account on pay decisions, by introducing a binding shareholder vote on the pay policy for directors of all quoted companies registered in the UK. The new reporting requirements will address the Commission's concern that it is often difficult to judge the full value of remuneration packages by requiring companies to publish a single figure for directors' pay in that year. In

addition, the new reporting requirements will include information similar to that proposed by the Commission, by requiring a company to set out the methodology and factors taken into account when pay decisions for directors are made, including maximum, minimum, and expected remuneration which can be awarded. The Government will ask the PRA and the FCA to consider further whether firms should specify the metrics they use for determining remuneration awards, and the need to discourage those which it considers inappropriate, as part of their wider work on the creation of a separate set of accounts for regulators (see chapter 5).

3 Reforming corporate governance

3.1 In its final report, the Commission builds on the analysis it set out in its report on the failure of Halifax Bank of Scotland (HBOS) and makes a number of recommendations including: supporting the role of shareholders and non-executive directors in challenging poor practice; strengthening governance at both board level and below; and improving corporate culture in banks.

3.2 The Government fully endorses the need to address these issues, and has already taken significant steps to do so. The recommendations in the Commission's final report will be key to the Government's ongoing strategy in this area, and the Government will continue to drive through these changes as part of the new Senior Persons Regime.

3.3 Mitigating risks to the long term sustainability of banks' business models and their general financial soundness will be a vital function of the new regulators at both systemic and firm levels. But first and foremost, banks' boards must be responsible for setting an appropriate risk appetite for their organisation, and managing those risks effectively. The recommendations of the Commission will strengthen Board effectiveness, and better enable them to carry out their roles to the standards expected.

Progress to date

3.4 Just as the Financial Services Authority (FSA) was criticised for its "tick-box" approach to regulatory oversight, there was also a failure of bank board oversight and capacity to intervene where necessary to address inappropriate risks. It does not necessarily follow that these banks were managed in an intentionally negligent way, but in many cases, especially in those of most serious failure, the capacity of senior managers to assess and control risk was inadequate. For example, in the case of HBOS, the board were unaware of the strategies being pursued in some areas of the company, and were further ignorant of the risks of that these strategies posed.

3.5 Boards have a responsibility for ensuring that institutions are well governed, for putting in place appropriate structures to support this, and for setting the values of the organisation. There is broad consensus that stronger corporate governance in financial institutions might have helped mitigate some aspects of the financial crisis. This is not just about process, but about how management exercise judgement, the practicalities of risk management, and the behaviour of the wider organisation.

Box 3.A: The failure of HBOS

HBOS pursued an aggressive asset-led growth strategy following the merger of Halifax and the Bank of Scotland (BOS) in 2000. The group rapidly expanded its commercial lending, especially in higher-risk segments such as commercial real estate. This lending growth was mostly funded through wholesale markets rather than customer deposit growth.

By 2008, HBOS's Commercial and International divisions were generating very significant losses. At the same time, the group suffered a significant decline in the market valuation of the structured investment portfolios held by its Treasury division. While it is clear that these losses would ultimately have led to insolvency, the immediate problem was an inability to meet its funding and liquidity requirements.

On 7 March 2013 the Parliamentary Commission on Banking Standards published *An accident waiting to happen: The failure of HBOS*.[1] The report highlights major failures in risk management at HBOS that allowed rapid growth of high-risk assets and over reliance on wholesale funding. In particular it cites:

- the group's "federal' structure", in which each division was largely responsible for its own risk management and which caused the board to misjudge its responsibility to oversee and intervene where necessary;
- the weaknesses of the Group Risk division and the lack of specialist risk management expertise among Group Risk Directors; and
- the lack of board knowledge concerning the business strategy and performance of the Commercial, International and Treasury divisions.

In the view of the Commission, there were also shortcomings in the FSA's oversight of HBOS, which led to concerns about the group's rapid expansion not being followed up.

The Government welcomes the work that the Committee has done to shed light on the factors that contributed to HBOS's collapse and is taking a number of steps to strengthen corporate governance in the financial sector, which are outlined below. The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) are currently considering the report's findings in more detail and will address these as part of a report to be published later this year.

3.6 Good governance is recognised as a critical characteristic of a business environment that promotes sustainable growth and makes the UK an attractive place for business and investment. The Government is committed to strengthening the UK corporate governance framework.

3.7 In the years since the financial crisis, the Financial Reporting Council's (FRC) UK Corporate Governance Code has been updated to reflect leading practice, and the Stewardship Code has been introduced, which sets expectations in how investors will exercise their stewardship responsibilities.

3.8 The Kay Review, commissioned in 2011,[2] has drawn international attention and the Government is now focused on implementing its recommendations. Following the work of Lord

[1] *An accident waiting to happen: the failure of HBOS*, The Parliamentary Commission on Banking Standards, Fourth Report of Session 2012-2013, April 2012 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/144.pdf

[2] *The Kay Review Of UK Equity Markets and Long-Term Decision Making*, Final Report, July 2012 – http://bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

Davies,[3] and the strengthening of the Corporate Governance Code reporting requirements to reflect this, the diversity of UK boardrooms is improving – although there is more work to do.

3.9 Reforms to company narrative reporting will encourage companies to focus their reports on the most important issues, and major reforms of the governance of executive pay in all quoted companies will come into force in October 2013.

3.10 The Government has also addressed issues within financial sector corporate governance specifically, and this will be strengthened through the new Senior Persons Regime.

Taking forward the Commission's recommendations

The role of shareholders

3.11 The Commission highlights its concerns that shareholders were not as effective as they could have been in challenging bank practice before the crisis. The Government recognises the unique and challenging position of institutional shareholders and the responsibilities that this entails. To this end, the FRC's Stewardship Code sets out best practice for institutional investors on the monitoring of, and engaging with, the companies in which they invest. It aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities, while making investors more accountable to their clients and beneficiaries for their stewardship activities. It sets a clear benchmark of the behaviour expected of all investors and an expectation that they disclose how they have applied the Stewardship Code.

3.12 The Stewardship Code has been strengthened by mandatory disclosure requirements for asset managers in the FCA rules. These new rules require UK authorised firms managing assets on behalf of professional clients to disclose the nature of their commitment to the Stewardship Code or to explain why it is not appropriate to their business model. This is global best practice, assisting their clients to make more informed decisions as to whom they get to manage their investments.

3.13 The Kay Review further examined the role of investors in equity markets in shaping the long-term performance and governance of UK public companies. The Government recognises the need for a shift in the culture of equity markets underpinned by steps to build relationships based on trust and confidence and to address misaligned incentives in the investment chain.

3.14 To the extent that these stewardship principles should apply to bondholders, and other creditors, the FRC has revised the Stewardship Code to encourage investors to disclose when they apply a stewardship approach to asset classes other than equities. The Government welcomes the challenge laid down by the Commission, for bondholders to raise issues of concern publicly where practical (674), and will ask the regulators to work with the FRC and the Financial Policy Committee (FPC) to consider the scope for bondholders of banks to take on a more active stewardship role.

Board level governance

3.15 The Commission also highlights where changes to board level governance and the nominations process are desirable, and where a number of improvements need to be made. It was found in the case of HBOS, that the knowledge of the business and the standard of challenge by board members was insufficient. The Capital Requirement Directive (CRD4) introduces specific, legally binding provision for improving risk oversight and mandating clearer lines of responsibility and accountability from the board level down, and the Government will be

[3] *Women on Boards*, February 2011 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31480/11-745-women-on-boards.pdf

updating its regulatory mechanisms in line with this. The Government will ask the PRA to consult on clear principles and standards to ensure effective oversight by the management body as part of this process.

3.16 The Commission makes several recommendations to address these issues which will be taken forward as part of the changes to the Senior Persons Regime. In response to concerns that the Chairmen of banks have hitherto not provided enough challenge and debate and to ensure that in future other non-executives have the tools and resources they need, the Commission recommends that the **Chairmen should have specific overall responsibility for leadership of the board as well for ensuring, monitoring and assessing its effectiveness** (712) and that **Chairmen should in future have an explicit responsibility for setting standards and providing effective oversight over how they are embedded through the organisation** (712).

3.17 In response to concerns that there is not enough assessment of Chairmen's performance, the Commission further 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** (712, 715, 717).

3.18 The Government will ask the regulators to consider introducing rules to ensure effective monitoring and oversight of the skills of the management board to ensure that they are able to understand the business of the institution, its main risk exposures, and the implications of the business and the risk strategy. These will include committing the management body to approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the institution is or might be exposed to, including conflicts of interest. Where changes are needed to the role of the Chairman, the Government will ask the PRA and FCA to consider taking these forward as part of the development of the Senior Persons Regime.

3.19 To address concerns that too few individuals with the character and capacity to challenge the board are appointed to non-executive director (NED) positions in banks, the Commission recommends that **the FRC 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** (706). The Commission also **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 to address concerns about transparency** (707).

3.20 New rules under CRD4 will go some way to addressing these recommendations. These include a commitment to encouraging greater diversity as regards age, gender, geographical provenance, educational and professional background to present a variety of views and experiences and facilitate independent opinions and critical challenge.

3.21 The Corporate Governance Code already sets out best practice on board appointments for listed companies, stating that the chair of the nominations committee should be the Chairman or an independent NED. The Corporate Governance Code has also been updated in recent years to increase constructive challenge and quality of decision-making by boards, for example: requiring more transparent appointment processes; increased emphasis on diversity of experience and approach in the boardroom to guard against "group think"; annual board evaluation, including independent evaluation every three years; and annual re-election of all directors to give investors more ability to hold the board to account.

3.22 As part of their annual monitoring of the implementation of the Corporate Governance Code the FRC have announced that they will consider the impact of these changes, whether there is evidence that problems remain across the listed sector as a whole and if there is a need

for further action. They will report on their conclusions in the annual report on the Corporate Governance Code, which will be published before the end of the year. As part of this, the FRC will consider if the Corporate Governance Code recommendation on how NED positions are advertised needs to be revised.

3.23 To address the issue of NEDs not having at their disposal sufficient resources and assistance to perform their challenge and oversight function well enough for a complex bank, the Commission recommends that **the office of the Chairman is well-resourced to enable it to provide independent research and support to the non-executive directors** (720). Further, 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, including the suggestion that the Chairman of a large bank should usually not hold any other large commercial non-executive or executive positions** (715).

3.24 The Government agrees that the office of the Chairman should be well-resourced to avoid the risk of CEOs trying to run chairs. The PRA already requires that the management body of an institution commit sufficient time to perform its functions, while CRD4 includes strict limits on the number of directorships of both executive directors and NEDs. To the extent that the Commission has recommended additional changes to the framework, the Government will ask the PRA and FCA to consider taking these forward as part of the development of the Senior Persons Regime.

Directors' responsibilities

3.25 The Commission suggests that **the Department for Business, Innovation and Skills (BIS) should consult on changing the duties of the directors of banks over the ring-fence threshold to prioritise the 'safety and soundness' of the firm first over the interests of shareholders** (708). The Commission's aim with this recommendation is clear: that the law specifies the duty of bank directors to safeguard the security of their firms in a way that ensures bank directors are never unclear about their responsibility to maintain bank stability.

3.26 The Government strongly agrees that bank directors must maintain an awareness of their responsibility to safeguard the security and stability of their firm. The Government fully accepts the need for changes that will have a real impact on bank directors' behaviour, and which will **support a focus on stability and soundness, for example by giving directors specific duties under the proposed Senior Persons Regime** (708). The Government therefore supports this recommendation and would encourage the PRA to reflect this in the proposed Senior Persons Regime and the PRA's Principles for Business. In addition, changes to introduce new criminal sanctions for recklessness will further sharpen directors' focus on their personal responsibilities and duties in respect of the firm.

3.27 Changing directors' duties for directors in banks over the ring-fence threshold has the merit of signalling clearly that shareholders' interests do not overrule the long term safety and soundness of the firm. But it may also have drawbacks. The enforcement of directors' duties is entrusted to shareholders or (new) directors. As the Commission notes, prior to the financial crisis many shareholders were not as effective as they could have been in challenging bank practices. It is consequently not clear that such a change to the duties would be effectively enforced.

3.28 What the crisis has shown is that the current regime for enforcing existing directors' duties in the banking sector has had an insufficient deterrent effect on bank directors' behaviour, and thereby failed to protect the public from harm. The Government will therefore seek views both on the Commission's specific recommendation as well as alternative options to strengthen the enforcement regime. Any recommendations for changes to the FRC's Corporate Governance Code would be contingent on the outcome of these deliberations.

3.29 As these issues potentially go beyond the financial services sector, the Government will seek views on all of these options in its forthcoming discussion paper on *Trust and Transparency*, which will be published before summer recess.

Below board level – internal controls and disciplines

3.30 The Commission scrutinises the standard of internal risk and compliance control, and internal audit below board level. Before the crisis these systems were held as having lower importance than the front-line divisions and burdened with responsibility for controlling risk, compliance or practicing internal audit for the whole company, an impossible task in most cases. The Commission recommends **a strengthening of the influence and independence of the Chief of Risk, Compliance and Internal Audit, and of their role within the institution** (729, 737, 741).

3.31 This approach includes direct access to accountable board members, independence from the senior management, and protection from dismissal unless all NEDs agree, and sufficient remuneration to preserve independence.

3.32 The Government agrees with this approach. These central functions are essential to the running of a bank in a proper and responsible fashion. The failure of HBOS revealed that without adequate information and support systems, a board is powerless to effect important change and oversight. The Government will therefore ask the PRA to consider consulting on new rules to ensure that the risk function shall be able to report directly to the management body, including the CEO, is independent from senior management and that the head of risk cannot be dismissed without approval by the management body.

3.33 The Government will ask the PRA and the FCA to consider the extent to which similar rules are necessary for the head of internal audit and compliance, alongside the introduction of new rules requiring the management body to ensure the integrity of the accounting and financial reporting systems, including risk, internal audit and compliance.

Culture

Diversity

3.34 The Commission also notes that **in banks overall, where the significant risks are often being taken – on the trading floor – the environment is overwhelmingly male. It recommends that banks should work to address this problem, and publish evidence of their progress** (769). The Government recognises this as an issue and is taking action to encourage greater diversity as regards age, gender, geographical provenance, and educational and professional background to present a variety of views and experiences and to facilitate independent opinions and critical challenge on boards, as noted above.

3.35 The Government agrees with the motivation behind this recommendation, especially the position that firms as a whole (and not just boards) should have an appropriate gender balance. To this end, BIS is legislating to require quoted companies to disclose detailed information regarding the gender breakdown of employees at board, senior management, and firm-wide level as part of its reforms to non-financial reporting. These changes are expected to become law before the summer recess this year, and will take effect from October 2013. Although these do not cover the "trading floor" specifically, the Government would encourage banks to consider disclosing gender breakdown in some business units and divisions as a matter of good practice in meeting this requirement.

Whistleblowing

3.36 The Commission made a number of recommendations **to ensure more effective arrangements for whistleblowing and better support for whistleblowers** (784, 786, 788, 791, 792, 796, 799, 803, 805), most of which are directed at the regulators and firms.

3.37 The Government recognises the important role that whistleblowing can play in exposing wrongdoing and takes the protection of whistleblowers seriously. BIS is publishing a "call for evidence" to establish a strong evidence base to help Government better understand the operation of the whistleblowing framework in today's employment environment and to facilitate the consideration of further changes to employment law. Evidence gathered through this exercise will allow further consideration to be given to the recommendations relating to the content of codes of conducts, support for regulators to maintain effective oversight of whistleblowing issues and the role the regulators can play with the whistleblowing information they have, including the interaction with Employment Tribunals. The Government will consider the Commission's recommendations in the context of this wider review.

4 Securing better outcomes for consumers through enhanced competition

4.1 The Commission concludes that effective competition plays an essential role in improving banking standards and consumer outcomes. The Government strongly agrees and is committed to improving competition in banking. The Commission makes a number of recommendations in this area, which will inform competition policy going forward. These include the setting up of an independent panel to examine the benefits of full account portability; and that the Government report on the merits of requiring the large banks to divest ownership of the payments systems. The Government has announced the creation of a new independent payments regulator who will be best positioned to take responsibility for both of these issues; and the Government will request that the new regulator publish full studies on both issues as an early priority. In addition, the Office of Fair Trading (OFT) has decided to bring forward its market review of small business banking. The Chancellor of the Exchequer has asked that as part of this work, the OFT review the impact on competition in small business enterprise (SME) banking, of new challenger banks created by divestments from the Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds).

Progress to date

4.2 The Government is committed to fostering a strong, diverse and competitive banking sector to ensure that UK consumers and the economy can benefit from high quality banking products and services at efficient prices. One of the impacts of the financial crisis has been an increase in the level of concentration in UK banking markets. The Government is determined to see a step change in competition in the UK banking market in order to achieve better outcomes for consumers.

4.3 The Government has taken significant steps to address this situation. Interventions have focused on:

- **reducing barriers to entry and expansion in the banking market**: in July 2012, the Chancellor of the Exchequer asked the Financial Services Authority (FSA) to conduct a Review of Barriers to Entry and Expansion in the banking sector, which resulted in major changes to the capital requirements for new banks, making it easier for them to enter the market and compete;

- **levelling the playing field by removing distortions in the market that favour large, incumbent banks**: for example, legislation has been introduced in the Banking Reform Bill to ring-fence banking services and increase banks' capacity to absorb losses. Introducing ring-fencing and measures on loss absorbency are key steps in helping to create the right environment for competition in banking to flourish;

- **making it easier for consumers to move their bank accounts to a provider that better meets their needs:** through a new 7 day switching service; and

- **improving transparency**: through the voluntary "midata" programme that the Government is undertaking with industry, which over time will give consumers increasing access to their personal data in a portable, electronic format. Individuals will be able to use this data to gain insights into their own behaviour and make better choices about products and services.

Taking forward the Commission's recommendations

Improving access to banking

4.4 Alongside a number of interventions which are already underway on banking competition, the Chancellor of the Exchequer announced on 19 June 2013 that **the OFT will bring forward its market review of small business banking** (404). This work has already begun and is focusing on competition in SME banking, including in the supply of services and lending to SMEs. As part of this work, the Government has requested that the OFT review the impact that the new challenger banks created by divestments from Lloyds and RBS will have on strengthening competition in small business banking.

4.5 The Government is also committed to improving access to financial services for individuals. Access to a transactional bank account is key to enabling people to manage their money effectively, securely and confidently on a day-to-day basis. The Government recognises the Commission's **recommendation that the major banks come to a voluntary agreement on minimum standards for basic bank accounts, or be subject to a statutory duty** (290, 291, 292). The Government is taking forward discussions with the banking sector and will provide further details later this year.

4.6 The Commission recommends that **HM Treasury examine the tax arrangements and incentives in place for peer-to-peer lenders to ensure a level playing field between mainstream and alternative finance providers** (359). The Government agrees that peer-to-peer lending and equity crowd funding are both important sources of non-bank finance. The Government is engaging with the peer-to-peer industry to examine their current tax treatment. Equity based platforms are already utilising the reliefs provided by the Seed Enterprise Investment Scheme and the Enterprise Investment Scheme.

4.7 The Government is also currently consulting on **a new social investment tax relief, intended to encourage private investment in social enterprise. As part of this, the Government will be considering the effectiveness of the Community Investment Tax Relief (CITR)** (299). The social investment tax relief consultation document notes that the Government will carefully consider the value of operating both CITR and the new social investment tax relief simultaneously, and question 26 asks respondents for their views on this.[1]

Reducing barriers to entry – creating a level playing field in payments systems and improving the authorisation process

Payments systems

4.8 In February 2013, the Chancellor of the Exchequer proposed the creation of a new payments systems regulator. A consultation on the scope, model, and duties of the proposed regulator was launched in March 2013. The establishment of such a regulator is necessary to create a level playing field in the payments systems with the large incumbent banks, which own the payment system companies and the infrastructure provider and, which dominate the Payments Council. The consultation on the payments regulator closed on 25 June 2013. The Government is currently analysing the responses, and intends to legislate by means of Government amendments to the Banking Reform Bill, with the aim of a new regulator coming into operation by the end of 2014.

[1] *Consultation on social investment tax relief*, HM Treasury and the Department for Business, Innovation and Skills, June 2013 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205414/consultation_on_social_investment.pdf

4.9 The Commission recommends **that the Government report on the merits of requiring the large banks to divest ownership of the payments systems** (334). The new payments regulator will be able to impose on payments systems and their participants certain conditions, which will require them to deliver open access, innovation, and better responsiveness to consumer needs. The regulator will have strong powers to ensure that this is achieved. The new regulator would have the power to require that the current owners divest themselves of the payments systems, if it decided this was necessary. The Government commits to ask the regulator, shortly after it takes on its responsibilities, to conduct and publish full studies on the ownership of the payments systems and on the case for and against taking action to force divestments.

Authorisation processes

4.10 In July 2012, the Chancellor of the Exchequer asked the FSA to conduct a Review of Barriers to Entry and Expansion in the banking sector. The FSA published their Review in March 2013[2]. It concluded that the new regulators (the Financial Conduct Authority – FCA and the Prudential Regulation Authority – PRA) should make significant changes to make it easier for new banks to enter the market and compete, as well as more proportionate regulatory requirements for smaller banks that do not pose a systemic risk.

4.11 As a result of the Review of Barriers to Entry and Expansion, the PRA has introduced major changes to their approach to setting capital requirements for new banks, which should significantly reduce the capital a new bank needs to hold. Liquidity requirements on new banks have also been made more proportionate: as with capital, new banks are no longer subject to additional liquidity requirements simply because they are newly authorised. To help level the playing field between the larger and smaller banks, the PRA will extend their new, more flexible approach to setting capital requirements for existing smaller banks that can be resolved in an orderly fashion without causing harm to the wider financial system.

4.12 The Review of Barriers to Entry and Expansion also recommended detailed changes to the authorisation process for new banks. The changes will make the process quicker and more transparent for applicant firms. In addition, the PRA and FCA have introduced a new authorisation process. This recognises that some applicants find it problematic to invest substantial sums of money, hire staff, and raise all the required capital without the assurance of being authorised. To help those applicants who are faced with these challenges, this new authorisation process grants authorisation, but with a restriction. This restriction limits what the new bank can do until it has passed through a longer mobilisation stage during which the bank completes all the remaining PRA and FCA conditions.

4.13 The Commission concludes that **the regulators' revised approach to authorising and approving new entrants requires close monitoring: it recommended the regulator report to Parliament in two years on this work** (327). The Government has asked the FCA and PRA to conduct a follow-up review on the barriers to entry and expansion work in 18 months time. This review will report on how these changes have made an impact, and whether further action should be taken. The PRA has also committed to publishing annual statistics on the performance of the authorisation process, including the average length of time it takes to receive a banking authorisation.

[2] *A review of requirements for firms entering into or expanding in the banking sector*, Bank of England and the Financial Services Authority, March 2013 – http://www.fsa.gov.uk/static/pubs/other/barriers-to-entry.pdf

Levelling the playing field

The role of the FCA and a competition objective for the PRA

4.14 The creation of the FCA through the Financial Services Act 2012 is a key step forward in improving outcomes for consumers. The FCA has been given new powers to allow it to intervene more swiftly to protect consumers from products that pose an unacceptable level of risk; to tackle misleading financial promotions; and to inform the public when a warning notice has been issued against a firm in relation to disciplinary action. Vitally, it has also been given a powerful mandate to promote effective competition in the interests of consumers, and a duty to consider competition in pursuing its consumer protection and market integrity objectives. This will equip the FCA to take swift and effective action to address competition problems in financial services.

4.15 Giving the FCA a competition objective and competition duty is a significant departure from the standard approach to regulating financial services. This is the first time that a UK financial services regulator will have a proactive role in promoting competition. The FCA has also been provided with enhanced powers to tackle competition issues. In particular, the FCA is able to use a suite of intervention tools, including Temporary Product Intervention Tools, to address concerns about the effectiveness of competition in markets.

4.16 **The Commission recommends that the FCA strategic objective of "ensuring the relevant markets function well" be dropped** (1074), as it risks diverting the FCA's focus on its core operational objectives, including its competition objective. While the Government welcomes the Commission's consideration of this issue, it does not agree with its conclusion. The strategic objective of the FCA was introduced through the Financial Services Act 2012, and was the subject of considerable scrutiny and debate during the Act's passage through Parliament. This objective was amended in line with the Independent Commission on Banking's (ICB) recommendations and endorsed by the Joint Committee that scrutinised the draft Financial Services Bill. The Government believes that the strategic objective will act as a high level "mission statement" that brings together the diverse aspects of the FCA's work. As such, it will serve a useful purpose in focusing the new regulatory culture of the FCA.

4.17 The **Commission has recommended that the PRA should be given a secondary competition objective** (1069) on the basis that its existing "have regard" duty with respect to competition is not strong enough. The Government is fully supportive of the need to ensure that the regulators understand and champion the need for competition in the financial sector. The Government agrees with this recommendation and will introduce the necessary amendment to give the PRA a secondary objective on competition in the Banking Reform Bill in the autumn.

Local and central government deposits

4.18 The Commission recommends that **the Department for Communities and Local Government (DCLG) review its guidance on deposits held by financial institutions originating from central or local government** (339). The Government welcomes the Commission's consideration of this issue and this has been considered by the Government relatively recently. The Government has not set rules on which institutions Local Authorities can deposit with since 2004. Since 2010, DCLG's guidance to Local Authorities on making investment decisions explicitly recommends that credit ratings – something many smaller banks do not have – should not be considered the only way to assess credit risk.[3] The framework is therefore already in place to ensure that Local Authorities can use institutions such as new banks that do not have a credit rating. However, DCLG has regular dialogue with the Chartered Institute of Public Finance and Accountancy (CIPFA) on Local

[3] *Guidance on Local Government Investments*, Department for Communities and Local Government, March 2010 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/11298/1501971.pdf

Authority treasury management practice, and will look to facilitate a dialogue between the two sectors on this issue. For central government deposits, the working balances of government departments are swept daily into high-level Exchequer accounts at the Bank of England. Transactional services on these accounts are provided by Citigroup and RBS who provide banking services under a contract with the Government Banking Service, but these banks do not have access to the deposits. Keeping these funds in the Exchequer rather than commercial bank accounts reduces government borrowing costs, as well as cash management costs.

Enabling quick and simple movement between account providers – examining the case for full account portability

4.19 High levels of concentration in key UK retail banking markets are an inhibitor to effective competition. The ICB identified a perception problem – with customers considering a change in bank account provider to be a risky and potentially costly undertaking – as contributing to low levels of current account switching in the UK. A recent survey conducted by the OFT found evidence that as many as 75 per cent of personal current account holders have never switched their account provider.

4.20 The Government has secured a commitment from industry to introduce a 7 day Current Account Switching Service (CASS) in September of this year. The new switching service will be free to use, come with a guarantee to protect customers in case anything goes wrong and will redirect any payments mistakenly sent to the old account for 13 months. Customers will also be able to choose the precise day on which they switch once they have opened a new account. For the first time, personal and SME current account customers will have a real option to move their accounts easily, quickly and without any inconvenience.

4.21 In line with the Commission's recommendation that **switching fees under the CASS do not impose disproportionate costs on new entrants or small banks** (380, 384), the Government has secured a commitment from the Payments Council that central development costs will be paid by the incumbent banks in line with their existing market shares. The ongoing cost-per-switch will be capped at £5 and split 50:50 between the acquiring and the ceding bank. In addition, **the Payments Council have been developing success criteria for the CASS** (387) and plan to make this public once it has been launched. The Government will also continue to monitor closely the success of the switching scheme.

4.22 The Commission recommended that **the Government initiate an independent study of the technical feasibility, costs and benefits of full account portability** (387). The Government has been clear that if the CASS does not deliver the expected consumer benefits, it will consider more radical options, including full account portability. The new payments systems regulator will be well positioned to consider, and if appropriate, force through proposals around the development of a "banking utility" or account number portability. The Government commits to asking the regulator, shortly after it takes on its responsibilities, to conduct and publish a full study of the case for and against account portability.

Increasing transparency – publication of statistics on price and service standards

4.23 Transparency around what products are on offer in the market and what they cost is essential for a well functioning market in banking services. The Government continues to work through its voluntary "midata" programme to extend transparency in the sector by facilitating services that can provide tailored advice by utilising electronic personal transactional data. Individuals will then be able to use this data to make more informed choices about the products and services they require and manage their financial lives more efficiently. The "midata" programme is also working on measures that will give customers the necessary confidence to

use such services and seeking ways to stimulate innovation with partners such as the Open Data Institute and the Information Commissioner's Office.

4.24 To help ensure the data is made available the Government took a power in the Enterprise and Regulatory Reform Act 2013 to enable it to regulate if insufficient progress is made through the voluntary programme. The Department for Business, Innovation and Skills (BIS) is working with the banking industry, HM Treasury and the regulators to establish measures that will benefit customers, against which progress can be reviewed.

4.25 The Government notes the Commission's recommendation that **the FCA should 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** (423), and the Committee's observation that **amendment to section 348 of FSMA on the disclosure of confidential information** (423) is likely to be necessary. The importance the Government places on greater transparency on the part of the regulators is reflected in the requirements of the Financial Services Act 2012 including the principle of transparency to which the FCA and PRA must have regard. The FCA has since published a discussion paper on its new transparency framework, which amongst other things discussed the possibility of placing requirements on firms to publish more information. The FCA is due to publish a feedback statement reporting on its findings this summer. The Government can confirm that the FCA and the PRA could place requirements on firms to publish certain types of information in line with the Commission's recommendation without engaging section 348, which controls the publication by the regulators of confidential information they receive whilst discharging their regulatory functions.

5 Enhancing financial stability

5.1 The 2008 crisis that hit the financial services sector across the world led to a huge burden on the taxpayer from bailing out banks and was fundamentally the result of a catastrophic failure of risk management at all levels of the system. 81 per cent of the Royal Bank of Scotland (RBS) and 39 per cent of Lloyds Banking Group (Lloyds) are still in public ownership.

5.2 The Commission highlights the need for good to come out of this unprecedented call on the public purse. It recommends that the Government should ensure that RBS is put in a position to make a full contribution to a better functioning market and support lending to business. The previous chapter sets out how these issues are a top priority for the Government's banking strategy. The Government fully endorses these aims. In response to the Commission's recommendation, the Chancellor of the Exchequer announced in his Mansion House speech on 19 June 2013, that HM Treasury will investigate the case for creating a so-called "bad bank" of RBS's risky assets.

5.3 The Commission also highlighted the role that inadequate regulation played in the financial crisis, particularly a focus on adherence to rules, rather than a judgement-led approach to assessing risk within an organisation. The Government agrees with this analysis, and has already made a great deal of progress in tackling the regulatory failures that helped to allow the financial crisis to develop through the Financial Services Act 2012.

5.4 In light of its concerns about the regulatory approach, the Commission has made a number of recommendations around the approach of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Many of these are for the regulators themselves. Other recommendations on the governance of the Bank of England and the PRA must be considered in light of the fact that the Bank of England now has a statutory objective for financial stability, and that it must be able to function in a way that enables it to be held accountable for fulfilling this responsibility.

Progress to date – RBS and Lloyds

5.5 During the financial crisis, £66 billion was injected into RBS and Lloyds to prevent them from collapsing. Lloyds received £20.5 billion, while RBS received £45.5 billion. As a result, the Government owns 39 per cent of Lloyds shares, and 81 per cent of RBS shares, including 65 per cent of RBS shares with voting rights. The Government also received a Dividend Access Share (DAS) in RBS, which entitles the Government to receive an extra dividend in priority to ordinary share dividends.

5.6 As the Chancellor of the Exchequer set out at the annual Mansion House dinner on 19 June, the Government's objectives for Lloyds and RBS are threefold:

- maximising their ability to support the British economy;
- getting the best value for money for the taxpayer; and
- returning them fully to private ownership.

5.7 The Government has been clear that it will only sell its stake in RBS when the bank is fully able to support the economy and when good value can be achieved for the taxpayer. RBS has made substantial progress since its near collapse in 2008, shrinking both the non-core assets and the investment banking operations.

5.8 As the Commission recognises, RBS has some significant remaining exposures to troubled assets. One option would be to transfer these assets from RBS into a run-off vehicle, usually described as a "bad bank." This would then enable RBS to focus on the good parts of its business, supporting the British economy and maximising the benefits for the taxpayer.

Taking forward the Commission's recommendations

The bad bank review

5.9 In line with the Commission's recommendation on RBS, the Chancellor of the Exchequer announced that **the Government would be reviewing the case for splitting RBS into a "good bank" and a "bad bank" of risky assets** (460, 498, 499) The review will be conducted by HM Treasury with external professional support and will look at a broad range of RBS's assets, but particularly assets in Ulster Bank and UK commercial real estate. A "bad bank" will only be set up if this review shows that doing so would achieve the Government's three objectives set out above. The Government will not put more taxpayer capital into RBS as part of this process.

5.10 Following the review, a decision on the creation of a "bad bank" will be made in autumn 2013. Once a decision is taken, the Government will discuss with the European Commission and RBS how the DAS can be removed while providing a fair return to the taxpayer. The current terms of the DAS limit RBS's ability to pay dividends, so its removal would be an important step towards full private ownership for RBS.

5.11 The Commission recommends that **the review should report 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** (499). The Government does not believe that the case for breaking RBS's core operations into multiple entities meets the objectives of maximising the banks' ability to support the British economy, getting the best value for the taxpayer or facilitating a return to private ownership.

5.12 The process of separating the banks' active businesses is costly, complex and time-consuming as illustrated by the ongoing divestments from RBS and Lloyds. Splitting RBS into multiple operating entities would generate significant additional costs, including from the creation of new systems for each resulting entity, the transfer of staff and customers and the need to provide each new entity with adequate capital and liquidity. This would risk undoing much of the good work that RBS has done in strengthening the bank in recent years. As the majority shareholder, the taxpayer would ultimately bear the majority of the costs. The Government has already made clear that it is not prepared to inject additional capital into RBS, which might be necessary under such a scenario should the costs exceed RBS's available resources. A prolonged restructuring of RBS's active business operations would also represent a barrier to the Government's ability to return the bank to private ownership and recover taxpayers' investment.

5.13 The prospect of a break-up on this scale would cause uncertainty and disruption for customers, creditors and staff, undermining the bank's ability to support the UK economy. The Government is fully committed to the objective of substantially strengthening competition in the banking sector. While a full break-up of RBS may be one way of pursuing this, the Government believes that other measures, as set out in chapter 4, potentially alongside any recommendations of the current Office of Fair Trading (OFT) review into competition into small

medium enterprise (SME) banking, would achieve this objective more effectively and at better value for UK taxpayers.

5.14 RBS and Lloyds are both already in the process of divesting part of their UK banking business as a requirement of European Union (EU) state aid rules, creating new challenger banks. The divestments are part of a package designed to correct the distortions to competition that followed the state support provided to RBS and Lloyds.

5.15 As set out in chapter 4, the OFT is reviewing the market for small business banking to make sure small firms get fair and competitive services from banks. As part of this review, the Government has asked the OFT to look specifically at the impact that new challenger banks created by Lloyds and RBS will have on strengthening competition in small business banking and identify what more can be done. The Government stands ready to consider whatever recommendations that emerge from the OFT's review.

Lloyds

5.16 The Commission notes that **Lloyds appears better placed to return to the private sector without additional restructuring** (511), and the Government agrees. Like RBS, its return to the private sector is premised on being able to support the UK economy. Lloyds has a clear strategy to focus on UK retail and commercial banking and is demonstrating strong progress in executing it. It is delivering on improvements in its operating performance, and has increasing regulatory clarity on its capital position following the recent Financial Policy Committee (FPC) and the PRA capital shortfall exercise for major UK banks.[1] Lloyds is also making good progress in winding down its non-core book.

5.17 The Government is now actively considering options for the sale of its Lloyds shares, with value for money for the taxpayer as the overriding consideration. The first tranche of Government shares is likely to be sold to institutions, but for subsequent disposals the Government will consider all options, including a retail offering to the general public. A decision on this will depend on market conditions at the time. The Government has not decided on a pre-determined timetable for this, nor has it set a target share price for the sales. The Government is not committed to any particular method of disposal.

UK Financial Investment

5.18 The Government's shareholdings are managed on an arms-length, commercial basis by UK Financial Investments (UKFI), which works closely with the banks' management to assure itself of their approach to strategy and to hold management rigorously to account for their performance.

5.19 The Government notes the Commission recommendation that **UKFI be abolished and absorbed within HM Treasury** (451) but, as the Chancellor of the Exchequer made clear in his Mansion House speech, does not accept it. UKFI is staffed by highly expert professionals with extensive experience in the banking sector. The Government continues to value the role of UKFI in managing the Government's shareholdings in state-owned banks.

Progress to date – reforming the regulation of financial services

5.20 The Government has made a great deal of progress in tackling the failures which allowed the financial crisis to develop, and in building the tools to deal better with bank failures in the future.

[1] *Prudential Regulation Authority (PRA) completes capital shortfall exercise with major UK banks and building societies*, News Release, 20 June 2013 – http://www.bankofengland.co.uk/publications/Pages/news/2013/081.aspx

5.21 The Government has ensured that the UK has moved further and faster than nearly any major economy to address risks in the financial sector. It has introduced domestic legislation to increase the resilience of financial institutions to shocks. The Financial Services Act 2012 fundamentally reformed the previous tripartite system by:

- giving the Bank of England clear responsibility for maintaining financial stability and establishing the FPC within the Bank, as a strong and expert macro-prudential authority;
- creating the PRA, a new micro-prudential regulator with responsibility for ensuring effective prudential regulation of firms that manage complex risks on their balance sheets, as a subsidiary of the Bank of England; and
- creating a new independent conduct of business regulator, the FCA, to ensure consumers are protected, market integrity is maintained and that swift and effective action is taken to address competition problems in financial services.

5.22 The Government has worked with partners in Europe to develop a new European System of Financial Supervision. This establishes a new set of European financial regulators that are tasked with identifying, managing and overseeing systemic risks and individual aspects of the financial system across the EU. The European banking Authority (EBA), which is an integral part of this system, is now headquartered in London. The Government has committed to the new, stringent capital requirements and liquidity requirements set out in the Basel III standards. The Government has also consistently called for a faithful implementation of Basel III in the EU.

5.23 Taken together, these changes will help to ensure that risks to financial stability at both institutional and systemic level are identified in a timely fashion and effectively managed. The PRA will take a fresh, judgement-based approach to supervising the firms within its jurisdiction, intelligently assessing their business models to ensure that they are sustainable and that risks they take on are properly managed.

5.24 The Government has also taken significant steps to ensure that when a financial institution does get into trouble, contagion to the rest of the sector and the wider economy is minimised. The Government set up the Independent Commission on Banking (ICB) to recommend further reforms to enhance financial stability, taking into account the UK's position as the home of a large international financial centre. The Government accepted the recommendations of the ICB and is putting them into law this year through the Banking Reform Bill.

5.25 The reforms being introduced in the Banking Reform Bill introduce safeguards to ensure that the failure of one bank does not lead to a more general crisis. The Bill separates retail and investment activities within a bank via a ring-fence. This will limit the possibility of the failure of an investment bank impacting on the banking services ordinary deposits rely on. In addition, the Bill introduces preference in insolvency for insured depositors, and sets out the framework for imposing loss absorbing debt requirements on banks. Both of these measures will ensure that, should a bank fail, losses should not fall on taxpayers. Working with European partners, the Government is also developing a framework for credible and effective tools to "bail-in" bank creditors and manage the failure of financial institutions.

5.26 The Commission has already played a vital role by carrying out pre-legislative scrutiny of the Banking Reform Bill publishing its *First Report* on 21 December 2012.[2] This made a number of

[2] *First Report*, Parliamentary Commission on Banking Standards, First Report of Session 2012-2013, December 2012 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/98/98.pdf

important and useful recommendations that improved the drafting of the Bill prior to its introduction to Parliament.

5.27 In particular the Government will "electrify" the ring-fence, meaning that the regulator will be given a power to impose structural changes on companies in a banking group that contain a ring-fenced bank if it considers, for example, that the conduct of other companies in the group is harming the ability of the ring-fenced bank to carry on providing vital banking services, or that the conduct of any member of the group is harming the regulator's ability to ensure the continuity of those services.

Taking forward the Commission's recommendations

Governance of the Bank of England and PRA

5.28 The Commission's report provides challenge on the Bank's governance structures. It reinforces the view previously taken by the Treasury Select Committee in its 2011 report on the Bank of England's governance, that **the Bank of England's Court should be reformed into a board** (1107). The Government does not support this recommendation. In substance the Court operates along the same lines as a modern PLC board. It has a clear division between the role of the Chief Executive (the Governor) and the non-executive Chair; it is made up of a majority of independent non-executive directors (NEDs); and there are formal, transparent appointment procedures for executive directors and NEDs alike.

5.29 Moreover, the Government believes that the Oversight Committee, a statutory sub-committee of the Court, which has considerably extended powers, represents an important step in improving the governance of the Bank of England. The Oversight Committee has a clear remit to commission retrospective policy reviews from both internal policymakers and eternal experts. Performance reviews will be published to ensure that the Bank of England is accountable to Parliament and the public. The Oversight Committee will be responsible for setting the terms of reference of the reviews and monitoring the Bank of England's implementation of any lessons learned. It will also review the procedures followed by the Bank of England's policy committees.

5.30 The Government believes it is important that the membership of the Committee is limited to the NEDs on Court, so it can remain independent from the policy process.

5.31 The Commission's report also recommends that **the senior independent board member, rather than the Governor should chair the PRA** (1108). However, the Government believes the Governor's role in chairing the PRA is vital. One of the key weaknesses of the failed tripartite system was a failure of coordination between those responsible for overseeing the financial system. In his role as Chair, the Governor will play a key role in ensuring that the PRA is coordinating effectively with the rest of the Bank of England group. This is important in order to ensure an effective and joined-up response to emerging threats to financial stability.

Membership of the Financial Policy Committee

5.32 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** (1115). The Government agrees with the Commission on the importance of ensuring that the FPC has the necessary expertise and experience to understand and draw the lessons from history and believes that the current membership of the FPC equips it to do so. The Government will take this into account, alongside all other relevant factors, when making future appointments to the FPC.

5.33 However, the Government is not persuaded that the balance of the FPC should be changed at such an early stage in its existence. The Government believes that the current composition of

the FPC strikes the right balance between ensuring there is sufficient input from the Bank of England, as executive, and internal Bank of England expertise, while supporting the external, non-executive members' role of providing a challenge to members' thinking.

5.34 Furthermore, the Oversight Committee will be able to undertake or commission reviews of the FPC's performance, ensuring that the FPC will be held to account for its decisions. The Oversight Committee will also monitor the processes of the FPC to ensure that all members have the required information and to tackle any emergence of "group think."

Bank of England's communication with Parliament

5.35 The Commission makes recommendations in relation to the Bank's communication with Parliament. The Government agrees with the **Commission's recommendation that the Bank should respond to all reasonable requests for information from Parliament** (1093), but believes that at present Parliament's wide ranging powers to hold public authorities to account make it unnecessary to introduce specific legislation in this context.

5.36 The Government also agrees that as a matter of honesty and integrity **the Governor should speak out if he has concerns about the influence exerted on government or the regulators through lobbying** (1113) by the financial services industry. The Government does not believe that a statutory duty is necessary to achieve this.

Regulatory and supervisory approach

5.37 The Financial Services Authority (FSA) was often criticised for relying too much on a "tick-box" approach to supervision, which did not effectively tackle problems arising from banks' business models, their governance, and their internal controls. The Financial Services Act 2012 therefore included a number of important measures to support a more forward-looking, judgement-led approach to regulation, the key change being the replacement of the FSA with two new regulators: the PRA and the FCA. Measures in the Financial Services Act 2012 to support a more judgement-led approach by the new regulators include:

- revision of the "threshold conditions" for authorisation so that they are now a more definitive statement of the minimum criteria that firms are expected to meet to have permission to carry out a regulated activity and to continue to meet on an ongoing basis;
- new more flexible powers for both regulators to impose "requirements" on firms in pursuit of their objectives;
- changes to the appeals process for both regulators; and
- a new "duty to supervise" for the FCA and PRA, which emphasises that their roles go beyond merely checking firms' compliance with rules.

5.38 The Commission's report welcomed the fact that both the FCA and PRA have now begun to set out their intentions for a new regulatory approach. In recognition of the fact that the FCA and PRA are new organisations the Commission recommends that **the Treasury Select Committee undertake an inquiry in three years time into the supervisory and regulatory approach of the regulators** (932, 946, 953). It also makes a number of recommendations for changes in the FCA or PRA's regulatory or supervisory approach directly to the regulators themselves.

Recommendations for regulators

5.39 The Commission recommends that the **regulators should have a new tool to enable them to place a bank on "special measures"** (970, 971). The Government welcomes the Commission's interest in this area and will carry out further work with the PRA and FCA on the specific

recommendation. However, the objectives of the recommendation seem achievable under the regulators' existing powers, so legislation to create a separate "special measures" regime appears unnecessary. There are also questions surrounding the potential for unintended consequences around disclosure of actions under such a regime.

5.40 The Commission also recommends that **a new autonomous body be created to assume the decision -making role of the Regulatory Decisions Committee (RDC) in relation to the banking sector** (1202). While the Government welcomes the Commission's consideration of this issue it does not agree with its conclusion. The current system gives the regulators discretion to design their decision making framework in a way that best suits their resources and regulatory approach. It is the case that an external RDC would be performing a role similar to that of a tribunal, and regulatory issues are already dealt with by the Upper Tribunal. The benefit of adding an extra layer of quasi-judiciary process is not clear and would likely lead to increased costs. This was a matter aired at some length during the passage of the Financial Services Act 2012. At this stage, the Government does not consider that change is required.

5.41 The Commission also recommends that **the FCA and PRA be required to make records of meetings between regulators and senior executives available to Parliament on request** (965). The Government fully agrees on the importance of ensuring the accountability of the regulators, although there are some difficult tensions with the need to maintain confidentiality and their operational independence, and therefore does not agree with the conclusion of the Commission. The Government believes it is appropriate that regulators are able to have confidential discussions with firms as a key part of effective regulation. The risk of records being made public could inhibit the willingness of firms to have open discussions in order to protect commercial sensitivities. It is also the case that the information the regulators hold is subject to statutory confidentiality and there are appropriate mechanisms for accountability to Parliament already in place.

Regulatory framework

5.42 As set out above, the Government has made a great deal of progress in managing risk at the level of the whole financial system. In particular, it has established the FPC and equipped it with appropriate tools and powers to mitigate the risks that it identifies in the banking system These include a counter-cyclical capital buffer, and time-varying sectoral capital requirements to ensure that financial institutions increase their capital buffers in the upswing of the credit and economic cycle, to enable them to better withstand shocks and keep lending when economic and credit conditions deteriorate.

5.43 These issues have also been at the heart of the Government's work with international partners on prudential regulation. The Government has worked hard for the full and faithful implementation of internationally agreed standards with regard to risk-weighted capital levels, leverage and liquidity in the EU. Many of these higher standards have been achieved through the Capital Requirements Directive (CRD4) and the Capital Requirements Regulation.

5.44 The Commission has, however, expressed concern about the dangers associated with excessive reliance on risk-weights and the reliance on internal models in the new loss-absorbency regime. Specifically, it recommends that **the Bank of England report to Parliament on the extent to which, in its view, the shortcomings of Basel II have been addressed by Basel III** (997). The Government shares the concerns raised by the Commission and many other experts that flawed risk-weightings played a major role in the last crisis, and that the mistakes of the past must not be repeated. The Government will also carefully consider how best to ensure that risk-weights are kept under review; that there is momentum to deliver real improvement in standards; and assurance that supervisory authorities are willing and able to take appropriate action to monitor and manage flaws in risk weighted assets calculations. It will also continue to press for progress

to be made in the Basel Committee and EBA reviews of risk-weights, and for appropriate concrete action to follow to ensure that weaknesses are identified and addressed.

Leverage ratio

5.45 The Commission recognises the importance of having a regulatory leverage ratio requirement to guard against problems in risk-weighting models. The Government wholeheartedly agrees with this analysis, and has consistently argued for a binding minimum leverage ratio requirement to be implemented internationally, to supplement the risk-weighting requirements. The Basel III standard will come into force in 2018, following an observation period from 2013 to 2017 and a final calibration of the leverage ratio in 2017. Separately the EBA will undertake a review of the leverage ratio framework in 2016 with a view to the European Commission introducing legislation in 2017.

5.46 In line with the Basel Accord agreement and the ICB recommendations, the Government believes that this requirement must act as a back stop measure. Risk-weighted capital requirements should remain the primary measure of prudential capital regulation.

5.47 The Commission concluded that the Basel III leverage ratio standard is too low, and has called for **the FPC to be given the power to determine leverage ratios much sooner than 2018** (1013). The Government recognises that question of the robustness of risk weights and the level and timing of the leverage ratio are important issues. There is extensive work underway at the European and global level to ensure flaws in the calculations of risk-weighted assets be addressed in a proper and consistent way and to determine the appropriate leverage ratio calibration in the banking sector.

5.48 The Commission repeated its recommendation made in its December 2012 report, which the Government addressed in its response.[3] The Government remains of the view that the minimum leverage requirement for deposit-takers and investment firms should, once agreed internationally, be defined by Basel III and its interpretation in European legislation.

5.49 The Government agrees with the Commission that the supervisory authorities must be fully equipped to respond and adapt to risks as they emerge, given that financial markets are innovative and fast evolving, with the nature of risks changing over time. The PRA has extensive powers to require that firms' risk models are appropriately conservative. It also has powers to set higher capital requirements – as evidenced recently when it announced that a number of large institutions needed to set out plans for improving their capital position – including taking actions to raise additional capital to meet a leverage ratio requirement.

5.50 The FPC has also been given a number of directive powers, including a counter-cyclical capital buffer and the power to set time-varying sectoral capital requirements (for example on specific classes of assets such as commercial real estate) to ensure that financial institutions increase their capital buffers in the upswing of the credit and economic cycle, and are better able to withstand shocks and keep lending when economic and credit conditions deteriorate. This issue has also been at the heart of the Government's work with international partners on prudential regulation. The Government has also made clear its intention to give the FPC the power of direction to vary through time the baseline leverage requirement for deposit takers and investment firms, subject to it never being below the requirement determined by Basel III. That power should be granted once the baseline requirement is implemented.

[3] *Banking reform: a new structure for stability and growth*, HM Treasury and the Department for Business, Innovation and Skills, February 2013 – http://www.official-documents.gov.uk/document/cm85/8545/8545.pdf

5.51 The Government believes it is still appropriate to grant the FPC this power from 2018, subject to a review in 2017, once the baseline requirement is implemented. This is to ensure that the UK leverage ratio framework is consistent with international standards and this timeline is consistent with the timetable for ICB implementation.

Differential taxation of debt and equity

5.52 The Commission notes that the long standing differential tax treatment of debt and equity has the potential to discourage banks from holding equity, and recommends that **the Government investigate addressing this through the introduction of an Allowance for Corporate Equity (ACE)** (1026).

5.53 The Government recognises that the current distinction in the tax system provides an incentive for businesses, including banks, to favour the use of debt over equity financing. In the case of banks, an ACE that encouraged higher levels of equity and reduced reliance on debt could provide financial stability benefits. However, other sectors of the economy may also benefit from an ACE. For example, the *Mirrlees Review*[4] made the case for the introduction of an ACE on an economy wide basis, as part of a package of reforms to increase corporate investment and economic output.

5.54 The introduction of an ACE could have a significant impact on tax revenues, and the proposal raises a number of wider policy and operational issues, which need to be worked through. For example, the Government would have to consider the implications for the recipients of distribution income on the grounds of maintaining balance in the tax system, and whether such a measure should be focused on a single sector.

5.55 The Government therefore welcomes the Commission's interest in this area and will review the wider case for an ACE as part of the consideration of tax measures for Budget 2014.

Accounting standards and auditors

5.56 Another area where the Commission has commented is in relation to the role of accounting standards during the crisis. Effective financial reporting is essential for the efficient operation of capital markets. Financial reports provide a vital communication link between companies and market participants, in order that investors (as the primary users) and other users can make economic decisions and assess the stewardship of management.

5.57 There is an important distinction to be made between financial reporting for investors and (prudential) regulatory reporting requirements which is aimed at ensuring the safety and stability of individual sectors and institutions. Financial Reporting (accounting) standards, based on clear principles, set the requirements for the provision of high quality, transparent and comparable financial information. For investors and companies, it is critical that this information is consistent and permits global comparison. The International Accounting Standards Board (IASB) is the independent standard-setting body responsible for the development and publication of International Financial Reporting Standards (IFRS). The Government remains of the view that the IASB is the right place to set, review, and agree changes to, international accounting standards.

5.58 In response to the suggestion that the move from UK Generally Accepted Accounting Principles (GAAP) to IFRS has destabilised the financial system, the Government has been clear that the crisis highlighted deficiencies and identified room for improvements in the accounting framework. However, it is important to note that accounting standards alone would be unable

[4] *Tax by Design*, Institute for Fiscal Studies, Mirrlees Review, chapter 17, September 2011 – http://www.ifs.org.uk/mirrleesreview/design/ch17.pdf

to provide a defence against the systemic problems that caused the banking crisis. Indeed, neither accounting standards nor audit have ever had an explicit financial stability role.

5.59 As a result of the financial crisis, and with the encouragement of the G20, the IASB has proposed a series of changes to financial instruments accounting through the development of a new accounting standard to be embodied in IFRS 9 – Financial Instruments. These revisions are being completed in phases, the first of which, on classification and measurement, was published in November 2009.[5] The new standard acknowledges the need to address the rationale for holding a particular financial asset or class of assets in determining the appropriate accounting treatment.

5.60 Another key revision is in respect of the rules around provisioning for loan losses, which some suggest were responsible for insufficient capital being held by the banks in the run up to the financial crisis. The IASB has published proposals to move to a forward-looking approach to loan loss provisioning. The new model will require banks to take into account expected losses when provisioning for loans. This is a distinct move away from the current "incurred loss" approach. This should improve stability and make sure that in the future banks will have to make larger provisions on the loans they make, enhancing the stability of the financial system. The new loan loss provisioning standard is not expected to be finalised before the end of 2013, after which it will be subject to an EU endorsement process for IFRS 9.

5.61 In response to the Commission's concern that **the new standard is not being implemented quickly enough** (1030, 1033), the Government agrees with the Commission that where new standards are available they should be used. The Government will continue to work with the European Commission, and within the current European governance framework, to push for the endorsement of each phase of the IFRS 9 standard as soon as it becomes available. At the international level, the Government has been clear that the completion of the work programme on the revision of IFRS 9 should be a key priority for the IASB.

5.62 The Commission further suggests a proposal to **require certain financial institutions to provide to regulators additional audited financial reports prepared on an alternative basis** (1039). While it may be argued that a parallel, more conservative, accounting regime for banks would mitigate some of the risks in the financial system, this needs to be balanced against the increased costs imposed by introducing a requirement for an additional parallel set of accounts.

5.63 The Government will therefore ask the PRA, working with the FPC and the banks, to review the nature and scope of information required to create a separate set of accounts for regulators and bring forward recommendations. This report will need to take a view on the costs and benefits of its production, including with regards to auditing this information on a mandatory basis, and on the need for a new statutory duty in this respect. This review should also include recommendations on the metrics and models used to measure profitability for remuneration purposes.

5.64 The Commission also recommends **the inclusion of specific commentary on matters of valuation, risk and remuneration in auditors' reports on banks' accounts** (1042). The Financial Reporting Council (FRC) has already issued revised guidance to the UK Corporate Governance Code that requires audit committee reporting about significant matters raised by the auditors; and requirements for auditors to include such matters in the auditors' report if the audit committee does not adequately do so, as well as a discussion of important risks and materiality considerations and how these affected the scope of their audit. The FRC is also working closely with the International Auditing and Assurance Standards Board (IAASB) as it develops parallel international proposals in relation to more transparent auditor reporting, and will consider how

[5] *IFRS 9: Financial Instruments (replacement of IAS 39)*, phases 1 to 3 available at – http://www.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognitio/Pages/financial-instruments-replacement-of-ias-39.aspx

to integrate this with the changes it has already introduced. Following the conclusion of the PRA's review of the nature and scope of information required to create a separate set of accounts for regulators, the Government will ask the PRA to consider whether the auditor should specifically address matters regarding valuation, risk and remuneration for banks in light of potentially enhanced reporting requirements in these areas.

Auditor dialogues

5.65 The Government agrees with the Commission that high quality dialogue and information sharing between bank auditors, the regulators, and tax authorities is desirable. As the Commission recommends, **the Government will ask HM Revenue and Customs (HMRC), the PRA and the FCA jointly to investigate where there is scope for usefully extending this dialogue** (1047), and report these findings to the Chancellor of the Exchequer by the autumn.

5.66 With respect to improved contact between external auditors and the supervisory authorities, the Government has taken action to ensure this dialogue is restored. To this end the Financial Services Act 2012 included a new section which requires the PRA to have arrangements for sharing information and opinions with auditors of PRA-authorised persons. The PRA has published a code of practice (as has the FCA) setting out how it will comply with this duty, and this code has been laid before Parliament. This means that there is an expectation set out in law, that there will be a regular dialogue between the regulator and auditor. The Government welcomes the recommendation that **the quality of this dialogue should be periodically reviewed** (1053), however, it notes that the PRA Board may be better placed than the Court of the Bank of England to do this. The Government is not convinced of the need to define the frequency of this dialogue in statute, as it is already included in the PRA code. However, based on the results of the proposed reviews of the quality of dialogue, **the Government will consider whether there is a case for the frequency of this dialogue to be defined in statute based on any further specific recommendations in these reviews** (1053).

6 Implementation of the Commission's recommendations

6.1 In line with the recommendation of the Commission, **HM Treasury has clarified in Annex A, for each recommendation, whether the Government, the Bank of England, the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA) will be in the lead** (1110). As a general principle, responses to the Commission's recommendations for changes to the regulatory or supervisory approach will be for the regulators to lead on, while the Government will usually lead on the response to changes to the legislative framework under which the regulators operate.

6.2 The Commission further recommends that, **in cooperation with the regulators, that the Government set out the timetable for implementation of each of the Commission's recommendations, specifying those that will require primary legislation** (1205). Those measures requiring primary legislation are summarised in Annex A. The Government, the Bank of England and the PRA, and the FCA will set out their timetables for implementing the Commission's recommendations in the autumn.

6.3 As set out earlier in this document and summarised in Annex A, the Government will make any necessary legislative changes required to implement those recommendations it has decided to accept through amendments to the Banking Reform Bill in the autumn. These will include amendments on:

- changes to the framework to enhance individual responsibility, in particular the creation of a Senior Persons Regime; the introduction of "banking standards rules"; amendments on reversing the burden of proof and time-limits for enforcement actions; and the introduction of criminal sanctions for reckless misconduct in the management of a bank; and
- the creation of a regulator of payments systems, which will come into effect in 2014.

6.4 Subject to further consideration with the regulators and the Bank of England, the Government will also consider whether legislation is required to implement the Commission's recommendation on establishing a requirement on the regulators to publish a range of statistical measures. This will be subject to the outcome of the FCA review of the new transparency framework and any constraints on disclosure of confidential information by the regulators arising from European Law. The Government will also further consider whether any legislation is required to enable the regulators to place a bank on "special measures". The Government will set out further detail on all these measures in the autumn, and if necessary, will bring forward amendments to the Banking Reform Bill in the House of Lords.

6.5 This document also highlights where the Government or regulators will be consulting or reviewing their policies in light of the Commission's recommendations. The Bank of England and the PRA, and the FCA will respond to the Commission's report in autumn 2013.

A The Commission's recommendations

A.1 The table below summarises for each recommendation, whether the Government, the Bank of England, the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA) will be in the lead. As a general principle, responses to the Commission's recommendations for changes to the regulatory or supervisory approach will be for the regulators to lead on, while the Government will usually lead on the response to changes to the legislative framework under which the regulators operate.

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
STRENGTHENING INDIVIDUAL RESPONSIBILITY					
SETTING AND ENFORCING STANDARDS FOR INDIVIDUAL CONDUCT					
1	Wider applicability of regime change 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.	656	Government PRA FCA	2.12	Yes
2	Senior Persons Regime – Government The Approved Persons Regime should 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.	612, 616, 617, 620, 626	Government	2.13	Yes
3	Senior Persons Regime – Regulators Regulators should 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.	618	PRA FCA	n/a	No
4	Senior Person Regime – Banks It should 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.	627	Industry PRA FCA	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
5	Reversing the burden of proof 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.	1170	Government	2.14	Yes
6	Time-limit for enforcement actions 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. 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.	1173	Government	2.14	Yes
7	Enabling approvals of Senior Persons to be subject to conditions Regulators should 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.	626	Government	2.14	Yes
8	The rebuttable presumption should not be introduced 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.	1170	Government	2.16	No
9	Criminal sanctions There is a strong case in principle for a new criminal offence of reckless misconduct in the management of a bank. The offence should be limited to individuals covered by the new Senior Persons Regime, so that those concerned could have no doubts about their potential criminal liability. 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.	1182, 1183	Government	2.17	Yes

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
10	Proposals for civil recovery of remuneration The Government should bring forward, after consultation with the regulators and no later than the end of 2013, proposals for additional provisions for civil recovery of remuneration from individuals who have been found guilty of reckless mismanagement of a bank	1184	Government	2.17	No
11	Post-civil enforcement action - taking criminal action 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.	1185	Government	2.17	Yes
12	Banking Standards Rules Regulators should 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 generally applicable to all individuals within the Licensing Regime, rather than sub-divided depending on category of employee.	634	Government PRA FCA	2.18	Yes
13	Licensing Regime 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. It would 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.	632, 633	Government	2.19	Yes
14	Implementation of the Licensing Regime by the Bank 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. An individual within the Senior Persons regime should be responsible for the performance of a banks Licensing Regime.	642, 643	Industry PRA FCA	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
15	Imposition of civil sanctions Legislation should 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 of failing.	1171	Government	2.19	Yes
16	Reforming the Register 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 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. The regulators should explore whether information about disciplinary dismissals could also be communicated to prospective employers	651	Government PRA FCA	2.20	No
17	International agreement 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 Commission recommends that the Government and the UK regulators initiate early discussions with US counterparts on this issue.	654	Government PRA FCA	2.20	No
18	Professional standards body Progress on professional standards can be achieved through the emergence of a credible professional body in banking. 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. 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.	596, 599, 601, 763	Industry	2.21	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
19	Enforcing fines 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.	1132	PRA FCA	n/a	No
20	Fines on banks recovered from the pool of deferred compensation as well as current year bonuses 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.	1131	PRA FCA Industry	n/a	No
21	Penalties for failure to bring issues to regulators' attention 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.	1133	Industry PRA FCA	n/a	No
22	Swift resolution and enforcement 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.	1134	PRA FCA	n/a	No
REMUNERATION					
23	Flexibility under CRD IV The UK Government and the Bank of England should 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 the Commission's recommendations.	896	Government PRA FCA	Box 2.A	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
24	Scope of application of proposals 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 Commission's proposals…should apply not only to all Senior Persons but also to all licensed staff receiving variable remuneration. The proposals require the careful examination of the remuneration of the highest risk Senior Persons Regime staff and spot checks on other licensed employees. A new Remuneration Code should be introduced on the basis of a new statutory provision, which should provide expressly for the regulators to prescribe such measures in the new Code as they consider necessary to secure their regulatory objectives.	900, 899	Government PRA FCA	2.32, 2.33, 2.34, 2.36, 2.37	No
25	Sales-based incentives The new Remuneration Code should 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.	864	Government FCA	2.35	No
26	Deferral of remuneration Legal and contractual arrangements should be developed whereby deferred remuneration comes to be seen as contingent, so that it can be recouped in a wider range of circumstances. 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 up to 10 years, where it is necessary for effective long-term risk management. Flexibility in the choice of instruments (form of deferral) is vital. Banks should make this choice, dependent on particular circumstances.	878, 880, 881	Government PRA FCA Industry	2.39, 2.40, 2.41, 2.42	No
27	Regulators role – new employment contracts 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.	886	PRA FCA Industry	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
28	Deferred remuneration as contingent Deferred remuneration should be seen as contingent, so that it can be recouped in a wider range of circumstances.	882	Government PRA FCA	2.45	
29	Recovery of vested remuneration In the most egregious cases of misconduct, recovery of vested remuneration may be justified. The regulator should examine 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.	883	Government PRA FCA	2.46	No
30	Void or cancel all deferred compensation in the event a bank receives state aid In the event that a bank is in receipt of direct taxpayer support in the form of new capital provision or new equity support, or a guarantee resulting in a contingent liability being placed on to the public sector balance sheet, the regulators have an explicit discretionary power to render void or cancel all deferred compensation, all entitlements for payments for loss of office or change of control and all unvested pension rights in respect of Senior Persons and other licensed staff.	884	Government PRA FCA	2.47, 2.48, 2.49	No
31	Remuneration of non-executive directors The new Remuneration Code should prohibit variable, performance-related remuneration of non-executive directors of banks.	890	Government PRA FCA	2.50	No
32	Change of employment/buyout: The regulators should come forward with proposals for domestic reform where banks hiring staff from competitors compensate recruits for the value they have forfeited, by awarding them equivalent rights in their own deferred compensation scheme. 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.	885	Government PRA	2.51, 2.52, 2.53	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
33	<u>Disclosure by bank remuneration committees</u> Bank remuneration committees should 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. 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. 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	863	Industry PRA FCA	2.55, 2.56	No
34	<u>Transparency and reporting requirements</u> The PRA should monitor remuneration carefully and report on it as part of the regular reporting of its activities. Banks' statutory remuneration reports should 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 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.	905	PRA Industry	n/a	No
REFORMING CORPORATE GOVERNANCE					
35	<u>Public disclosure of banks to bondholders</u> It is good practice for banks to publicly disclose and make widely available, the contents of their presentations to bondholders. Bondholders, where they are sufficiently concerned, should raise such issues publicly where practical. The PRA should examine the scope for extending bondholder influence of this type.	674	Government FPC PRA FCA FRC Industry	3.14	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
36	Direct personal responsibility on the chairman The importance of the Chairman's role should be reflected in the post's responsibilities under the proposed Senior Persons Regime. A full-time Chairman should be the norm. The implication is that the Chairman of a large bank should usually not hold any other large commercial non-executive, let alone executive, positions. 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. The regulator should maintain dialogue with the Senior Independent Director.	712, 715, 717	Government Industry PRA FCA	3.16, 3.17, 3.18, 3.24	No
37	Nomination Process 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 Financial Reporting Council should examine whether a Nomination Committee should be chaired by the Chairman of a bank or by the Senior Independent Director.	706	FRC	3.19, 3.22	No
38	The role of non-executive directors 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.	729	Government PRA FCA Industry	3.18, 3.24	No
39	Publicly advertising non-executive vacancies of a bank above the ring-fence threshold The regulators should examine the merits of requiring each non-executive vacancy on the board of a bank above the ring-fence threshold to be publicly advertised.	707	Government FRC	3.19, 3.21, 3.22	No
40	Resourcing the Office of the Chairman 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.	720	Government PRA FCA	3.23, 3.24	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
41	Directors duties The UK Corporate Governance Code should 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 PRA Principles for Businesses should 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 responsibilities of Senior Persons who are directors should include responsibilities to have proper regard to the safety and soundness of the firm. The Government should 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.	708	Government PRA FCA	3.25, 3.26, 3.27 3.28, 3.29	Yes
42	Independent Chief Risk Officers 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.	729	Government PRA FCA Industry	3.30, 3.31, 3.32	No
43	Independent Compliance Dismissal or sanctions against the Head of Compliance should only follow agreement by the non-executive directors.	737	Government PRA FCA	3.33	No
44	Independent internal audit 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.	741	Government Industry	3.33	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
45	Responsibility for acting in accordance with regulation should lie with every individual in a bank 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.	735	Industry	n/a	No
46	Gender balance on the trading floor 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.	769	Government Industry	3.34, 3.35	No
47	Whistleblowing – senior responsibility 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. The Board member responsible for the institution's whistleblowing procedures should be held personally accountable for protecting whistleblowers against detrimental treatment.	788, 791	PRA FCA	3.36, 3.37	No
48	Whistleblowing – role of regulators All Senior Persons should have an explicit duty to be open with the regulators. 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 regulator should 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.	796, 799	PRA FCA	3.36, 3.37	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
49	Whistleblowing – financial incentives The regulator should undertake research into the impact of financial incentives in the US in encouraging whistleblowing, exposing wrongdoing and promoting integrity and transparency in financial markets.	803	PRA FCA	3.36, 3.37	No
50	Whistleblowing – duty to report Institutions must ensure that their staff ave 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.	784	Industry	3.36, 3.37	No
51	Whistleblowing – mechanisms in place to raise concerns 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.	786	Industry	3.36, 3.37	No
52	Whistleblowing – internal filter Whistleblowing reports should be subjected to an internal 'filter' by the bank to identify those which should be treated as grievances. 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.	792	Industry PRA FCA	3.36, 3.37	No
53	Empowering regulators where a whistleblower has not been treated properly 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.	805	PRA FCA	3.36, 3.37	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
SECURING BETTER OUTCOMES FOR CONSUMERS THROUGH ENHANCED COMPETITION					
54	CMA review of retail and SME banking sector 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.	404	Government	4.4	No
55	Voluntary agreement basic bank accounts Major banks should come to a voluntary arrangement which sets minimum standards for the provision of basic bank accounts. In the event that the industry is unable to reach a satisfactory voluntary agreement within the next year, the Government should 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. The Government also needs to ensure that the agreement, voluntary or not, is underpinned by a requirement on the FCA to uphold minimum standards.	290, 291, 292	Industry Government	4.5	No
56	Creating a more diverse retail market The FCA should ensure that other forms of provision in the retail banking market 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.	343	PRA FCA	n/a	No
57	Peer-to-peer and crowdfunding platforms The Treasury should 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.	359	Government	4.6	No
58	FCA regulation of alternative providers such as peer-to-peer lenders Regulation of alternative providers such as peer-to-peer lenders must be appropriate and proportionate and must not create regulatory barriers to entry or growth.	356	FCA	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
59	Treasury review of tax incentives including CITF The effectiveness of current tax incentives, including Community Investment Tax Relief, intended to encourage investment in CDFIs by banks and other funders, should also be reviewed by the Treasury and, where necessary, re-designed to be more effective.	299	Government	4.7	No
60	Payments regulation Ownership of the payments system remains largely in the hands of the large incumbent banks. The merits of requiring the large banks to relinquish ownership of the payments system should be examined and that the Government report to Parliament on its conclusions before the end of 2013.	334	Government	4.9	Yes
61	Practical application of barriers to entry 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. The practical application of the regulatory authorities' laudable statements needs to be monitored closely.	323	Government	4.10, 4.11, 4.12	No
62	Regulators reporting on progress on approving new entrants in 2 years time 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.	327	Government PRA FCA	4.13	No
63	FCA's strategic objective The FCA's strategic objective of "ensuring that the relevant markets function well" should be dropped.	1074	Government	4.16	No
64	FCA embedding a pro-competition culture 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.	1078	FCA	n/a	No
65	PRA competition objective The PRA should be given a secondary competition objective. A 'have regard' to competition simply does not go nearly far enough.	1069	Government	4.17	Yes

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
66	DCLG guidance on deposits DCLG review its guidance on deposits held by financial institutions originating from central or local government, 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.	339	Government	4.18	No
67	Account switching fee 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 per-switch fee should not be borne wholly by either the new bank acquiring the customer or by the bank losing the customer.	380	Industry	4.21	No
68	Reviewing account switching The Government nor the Payments Council have established benchmarks to measure the impact of the new service.	384	Government	4.21	No
69	Account portability The Government should immediately initiate an independent study of the technical feasibility, costs and benefits of the full range of options for account portability. Such a study must be conducted by an independent body rather than one linked to the industry. The Treasury should establish an independent panel of experts to consult widely and report on portability. It should report within 6 months of its establishment on switching and within 12 months on other issues.	387	Government	4.22	No
70	Transparency and amending S348 of FSMA The FCA should 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.	423	Government FCA	4.25	No
71	Price transparency It should be regulators duties, wherever possible, to ensure maximum price transparency at every level of banking.	536	FCA	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
72	Widening access to FOS The FCA should consult on options for widening access to the Financial Ombudsman Service (FOS) for small businesses.	523	FCA	n/a	No
73	FCA requiring banks to write to consumers on PPI The FCA should 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	530	FCA	n/a	No
74	Banks taking customer complaints seriously The evidence suggests that too often the banks have not taken customer complaints seriously. […] The regulators should consider this as a matter of urgency.	532	FCA	n/a	No
75	FOS case handling fee Regulators should consider, as a matter of urgency the case for a 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.	532	FCA	n/a	No
76	Checks on customers' understanding of the transactions entered into 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 FCA should examine periodically whether banks' systems for carrying out their own assessments are adequate.	416	Industry FCA	n/a	No
77	BBA and banks commitment to refer declined loans to CDFIs 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.	298	Industry	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
ENHANCING FINANCIAL STABILITY					
78	RBS bad bank review The Government should immediately commit to undertaking a 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, by September 2013. The Government should publish its work on a good bank / bad bank split. In considering reprivatisation of RBS, the Government should try to ensure best value for the taxpayer and the wider interests of the UK economy.	460, 498, 499	Government	5.9, 5.10	No
79	Splitting RBS good bank into multiple entities The Government should 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.	499	Government	5.11, 5.12, 5.13, 5.14, 5.15	No
80	Lloyds 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.	511	Government	5.16, 5.17	No
81	UKFI UKFI should be wound-up and its resources absorbed back into the Treasury.	451	Government	5.18, 5.19	No
82	Court of the Bank of England to be reformed into a Board The Court of the Bank of England should 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.	1107	Government Bank of England	5.28. 5.29, 5.30	No
83	Chair of the PRA A senior independent Board member should chair the PRA. The Governor should remain a member of the board of the PRA.	1108	Government	5.31	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
84	FPC historian An additional external member should 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.	1115	Government	5.32, 5.33, 5.34	No
85	Bank of England providing information for Parliament The Bank of England should have a duty to respond to reasonable reports for information from Parliament	1093	Government Bank of England	5.35	No
86	Governor of the Bank of England sounding the alarm on bank lobbyists 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. It should be the specific personal responsibility of the Governor to warn Parliament, or the public in such circumstances.	1113	Government Bank of England	5.36	No
87	TSC inquiry on regulatory approach The Treasury Committee should undertake an inquiry in three years' time into the supervisory and regulatory approach of the new regulators.	932	Treasury Select Committee	5.38	No
88	TSC assessment on FCA's approach to data collection 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.	946	Treasury Select Committee	n/a	No
89	TSC consider FCA's use of product intervention tools The Treasury Committee should specifically consider the FCA's use of its product intervention tools in its inquiry into the supervisory approach.	953	Treasury Select Committee	5.38	No
90	Introduction of a special measures tool The regulators should have available to them a "special measures" tool to identify and tackle serious failings in standards and culture within the banks they supervise. Special measures will take the form of a formal commitment by the bank to address concerns identified by the regulator.	970, 971	Government PRA FCA	5.39	No

No.	Recommendation	Paragraph no. in Commission’s report	Lead	Paragraph no. in Government response	Legislation
91	Regulatory Decisions Committee 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 statutory autonomy within the FCA. It should be appointed by agreement between the boards of the FCA and PRA. The FCA and the PRA should publish a joint review of the working of the enforcement arrangements for the banking sector in 2018. This should consider whether a separate statutory body for enforcement as a whole has merit.	1202	Government PRA FCA	5.40	No
92	Records of meetings between regulators and senior executives The FCA and the PRA should 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.	965	Government PRA FCA	5.41	No
93	Bank of England – Basel III 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.	997	Bank of England	5.44	No
94	Leverage ratio The Government should relinquish political control over setting the leverage ratio. If the Government maintains its current position, the newly-established FPC publish its own assessment of the appropriate leverage ratio. 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.	1013	Government	5.45, 5.46, 5.47, 5.48, 5.49, 5.50, 5.51	No
95	Tax – Consultation on Allowance for Corporate Equity The Government should consult on whether to introduce a limited form of an Allowance for Corporate Equity for the regulated banking sector alongside a uplift in the Bank Levy to offset the cost to the Exchequer in full.	1026	Government	5.52, 5.53, 5.54, 5.55	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
96	International negotiations on accounting standards 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	1030	Government	5.57, 5.61	No
97	Accounting – Decision on expected loss model The FRC should prioritise an early decision on the expected-loss model for valuation of debt assets held to maturity for the banking sector in EU negotiations	1033	Government FRC	n/a	No
98	Accounting – separate accounts Flaws in IFRS mean that the current system is not fit for regulators' purposes. Non-EU mandated regulatory returns should 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 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.	1039	Government PRA FPC	5.62, 5.63	No
99	Auditors reports to include subjective matters Auditors' reports on banks' accounts should include specific commentary on subjective matters of valuation, risk and remuneration, amongst other key judgement areas, that are crucial to investors' understanding of a bank's business model.	1042	Government FRC FPC	5.64	No
100	Sharing of information and expertise HMRC, PRA and FCA should jointly publish a paper setting out how they intend to bring about appropriate useful sharing of information and expertise within the existing rules.	1047	Government	5.65	No
101	Periodic review on PRA promoting information sharing The National Audit Office undertake a periodic review of how effectively the PRA uses its powers to promote information sharing	1047	Government	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
102	Dialogue between auditors and supervisors The Court of the Bank of England should commission a periodic report on the quality of dialogue between auditors and supervisors. 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.	1053	Bank of England PRA FCA	5.66	No
103	Regulators acting as shadow directors 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 regulators should report to the Treasury Committee within six months.	942	PRA FCA	n/a	No
104	Banks duty on new products Banks should 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. Those who design and market products should be have personal responsibility which must be clear under the Senior Persons regime.	954	Industry	n/a	No
105	Super complaints The FCA should provide clear reasons when it does not consider that initiation of a collective consumer redress scheme is appropriate.	957	FCA	n/a	No
106	PRA and FCA mobilising the experience of former senior management in the banking industry The advice and evidence of some experienced bankers untainted by recent crises has been extremely helpful in exposing the flaws we have identified in the banking industry and in proposing remedies. The PRA and FCA should 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	911	PRA FCA	n/a	No
107	FCA powers of restitution FCA should have powers they need to ensure restitution to be made as a result of the interest rate swap scandal	19	FCA	n/a	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
108	<u>Awareness of staff by regulators</u> 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.	982	PRA	n/a	No
109	<u>FCA operating at lower cost</u> The FCA should 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.	985	FCA	n/a	No
110	<u>European constraints on PRA regulatory approach</u> 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.	998	PRA	n/a	No
111	<u>Removing dependency on credit rating agencies</u> Progress by regulators internationally in weaning themselves off dependence on credit rating agency ratings for the purpose of assessing capital adequacy is essential. Regulators should prepare a report for Parliament on progress made and further plans for action by June 2014.	1002	Bank of England PRA FCA	n/a	No
112	<u>Regulators consider the case for investigation led by an independent person</u> Where regulatory failure may also be an issue in the failure of the bank, regulators should consider undertaking reports to examine what goes wrong in banks, the regulators should consider the case for an investigation led by an independent person appointed with the approval of Parliament	1003	PRA FCA	n/a	No
IMPLEMENTATION					
113	<u>Lead responsibility on the Commission's recommendations</u> The FCA, the PRA and the Government prepare, for publication alongside the Government response, 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.	1110	Government PRA FCA	6.1	No

No.	Recommendation	Paragraph no. in Commission's report	Lead	Paragraph no. in Government response	Legislation
114	<u>Timetable for implementing recommendations</u> The Government, in cooperation with the regulators, should set out the timetable for implementation of each of the Commission's recommendations, and specify those that will require primary legislation.	1205	Government PRA FCA	6.2	No

B Government response to the Commission's second report

B.1 The Commission's second report, *Banking reform: towards the right structure*, was published on 11 March 2013[1] in response to the Government's response to its pre-legislative scrutiny of the Banking Reform Bill. The report welcomed the commitments made by the Government to implement a number of significant recommendations made by the Commission in its *First Report*,[2] including provision for a firm-specific separation power. The report also included a series of amendments drafted by the Commission, giving legislative expression to those recommendations it put forward in its *First Report*, but were not adopted by the Government for inclusion in the Bill at introduction.

B.2 These amendments were tabled in full by the Opposition at Commons Committee stage, which began on 19 March 2013, and formed a useful and constructive basis for debate. During the Committee's deliberations, the amendments were scrutinised in detail, and the Government set out its position on each of the Commission's legislative recommendations.

B.3 The Government agreed to consider a number of the Commission's amendments. The Government is now bringing forwards its own amendments to implement the following measures at Report stage of the Bill, in response to the Commission's recommendations:

- changes to the wording of the regulator objectives to clarify that regulators will be required to minimise the risk that failure of *any* member of a ring-fenced body's group might affect the continuity of core services;
- a requirement for HM Treasury to consider competition issues when deciding whether to impose, remove or vary a *de minimis* threshold; and
- a requirement for the Prudential Regulation Authority (PRA) to commission a report into any application for a ring-fencing transfer scheme, including a statement of whether third parties are likely to be adversely affected by the scheme, and whether such effects are greater than reasonably necessary to achieve the purposes of the scheme.

B.4 Full transcripts of the Public Bill Committee's deliberations are available at: www.parliament.uk.

[1] *Banking reform: towards the right structure*, The Parliamentary Commission on Banking Standards, Second Report of Session 2012-2013, March 2012 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/126/126.pdf

[2] *First Report*, Parliamentary Commission on Banking Standards, First Report of Session 2012-2013, December 2012 – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/98/98.pdf

Government response to the Commission's third report

C.1 The Commission undertook a separate report into proprietary trading on 15 March 2013.[1] This annex sets out the Government's response to that report. **The Government agrees with the Commission that the risk resulting from proprietary trading can be considerable and should be properly controlled.** A bank risking its own capital seeking a profit through proprietary trading can potentially result in losses of a magnitude to destabilise the overall capital position of the bank. The large losses incurred for example by the "London Whale" at JP Morgan showed how individual positions from a single trading desk can potentially result in very substantial losses for the whole bank.

C.2 The Commission heard that most large UK banks have pulled out of having standalone desks conducting purely speculative proprietary trading. The Commission also noted the considerable challenges and delays in countries which have tried to ban proprietary trading altogether, such as the US, in the form of the "Volcker rule." The difficulty in implementing such a ban stems from the fact that market making and proprietary trading can be indistinguishable in practice. Both involve buying and selling securities and both can potentially expose a bank to large losses. The key difference lies in the intent behind the trading, which is difficult for supervisors to observe.

C.3 Since UK banks appear not to engage in standalone proprietary trading at the moment, and given the legal and operational challenges of implementing a ban, the Commission concluded **that there are not sufficient grounds to ban proprietary trading at the current time.** The Government agrees with this assessment. A similar view has also been expressed by Sir John Vickers in previous evidence sessions. Sir John Vickers was also concerned that, given the challenges of enforcement, introducing a Volcker Rule in addition to ring-fencing could dilute regulatory focus on the ring-fence, weakening its effectiveness.

C.4 The Commission focussed its recommendations on the way the regulator currently addresses the risks from potential proprietary trading operations. Specifically it recommended that:

- **the regulator monitors operations within banks that might conceivably carry out proprietary trades.** As Andrew Bailey, the Deputy Governor for Prudential Regulation pointed out in his response to the Commission, the Prudential Regulation Authority (PRA) monitors firms' adherence to their stated risk appetite which should be consistent with the PRA's objective of ensuring the safety and soundness of the firms it regulates;
- **the Government consult the PRA whether it has sufficient powers to address issues arising from proprietary trading.** The Government consulted the PRA and ascertained that no further legislative change is necessary to allow the PRA to scrutinise banks' approach to proprietary trading; and

[1] *Propriety Trading,* Parliamentary Commission on Banking Standards, Third Report of Session 2012-2013, March 2013

- **the PRA carries out a report on the actions it has taken to bear down on proprietary trading activities in the UK as well as a case for and against a ban**. Given the limited evidence presented to both the Commission and the Independent Commission on banking (ICB) on the merits of a ban on proprietary trading the Government does not at this stage intend to ask the PRA to carry out such a report. The regulator already has extensive reporting requirements which it will be expected to use to highlight emerging risks, including those from proprietary trading. The Government will follow closely the way in which other countries are able to implement bans on proprietary trading and will regularly confer with the regulator to learn more about the level of suspected proprietary trading throughout the financial system.

C.5 In its response to the Commission, the PRA also set out that the types of large open positions characteristic of proprietary trades are subject to stringent capital requirements, with a further strengthening of standards likely to be agreed following the fundamental review of the trading book by the Basel Committee. The Government believes that tough capital requirements throughout the financial system mitigate some of the potential risk posed by proprietary trading operations.

Summary of consultation responses to sanctions for the directors of failed banks

D.1 The consultation document *Sanctions for the directors of failed banks*[1] sought comments on:

- a proposal to introduce a "rebuttable presumption" that a director of a failed bank is not suitable to be approved by the regulator to hold a position as a senior executive in another bank; and
- the possible introduction of criminal sanctions for serious misconduct in the management of a bank.

Rebuttable presumption

D.2 There were two questions on the "rebuttable presumption" proposal:

- on the proposal itself; and
- on possible supporting measures aimed at clarifying management responsibilities and regulatory duties of bank directors.

D.3 More respondents who commented on this proposal were opposed or sceptical than supportive. Many respondents were concerned that it would not be consistent with the "presumption of innocence" or would be unfair to the individuals concerned – for example, because they might not have access to the information to demonstrate that they were not responsible for a bank failure. Some respondents took the view that the proposal was unnecessary as the Financial Services Markets Act 2000 (FSMA) Approved Persons Regime already required regulators to give their approval before a candidate took up a senior executive position. Some respondents were concerned that the measure might deter individuals from taking up board appointments in banks, especially in banks which were having problems and looking to recruit new directors to lead rescue efforts. One respondent was concerned that the proposal would add to the difficulties in recruiting directors for building societies.

D.4 Some of the respondents who supported the proposal shared some of these concerns. Other respondents felt the proposal did not go far enough and there should be an automatic bar on directors of failed banks holding new board appointments, or that the threshold to rebut the presumption should be set at very high level.

D.5 Fewer respondents commented on possible supporting measures and responses were mixed. While some respondents felt that greater clarity about management responsibilities would be helpful, there were concerns about introducing unhelpful rigidities in the specification of management responsibilities or a "tick-box" approach to clarifying individual responsibilities.

[1] *Sanctions for the directors of failed banks*, HM Treasury, July 2012 – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81565/consult_sanctions_directors_banks.pdf

There were also concerns that additional regulatory duties would lack clarity or add little to existing requirements.

Criminal sanctions

D.6 There were two questions on possible criminal sanctions:

- the general question on criminal sanctions; and
- a request for views on possible formulations of the offence – the consultation document indicated that the Government considered recklessness to be the appropriate basis for a new criminal offence.

D.7 A clear majority of the respondents who commented on this proposal were opposed to the introduction of criminal sanctions.

D.8 There were concerns that the introduction of criminal sanctions would deter people from becoming bank directors. There were also concerns that it would add little to existing regulatory powers over approved persons, existing criminal offences and company law requirements, especially in the view of the costs and duration of investigations and criminal prosecutions. One respondent suggested amending the Company Directors Disqualification Act 1986 as an alternative to a new criminal offence.

D.9 Those respondents who commented on the formulation of the offence generally favoured using recklessness as the basis for a new criminal offence.

TSO
information & publishing solutions

Published by TSO (The Stationery Office) and available from:

Online
www.tsoshop.co.uk

Mail, telephone, fax and email
TSO
PO Box 29, Norwich NR3 1GN
Telephone orders/general enquiries: 0870 600 5522
Order through the Parliamentary Hotline Lo-Call 0845 7 023474
Fax orders: 0870 600 5533
Email: customer.services@tso.co.uk
Textphone: 0870 240 3701

The Houses of Parliament Shop
12 Bridge Street, Parliament Square,
London SW1A 2JX
Telephone orders/general enquiries: 020 7219 3890
Fax orders: 020 7219 3866
Email: shop@parliament.uk
Internet: http://www.shop.parliament.uk

TSO@Blackwell and other accredited agents

HM Treasury contacts

This document can be downloaded from
www.gov.uk

If you require this information in another
language, format or have general enquiries
about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-0-10-186612-5