Strengthening accountability in banking

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William Yonge, Partner in the Investment Management Group of Morgan Lewis, London, explains the tougher standards for individuals in the sector that will come into force from March 2016.

William Yonge
Morgan Lewis

The UK Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) published a joint consultation paper in July 2014 aimed at increasing the standards of personal accountability and strengthening the regulation of individuals who work in UK-incorporated banks, building societies, credit unions, and PRA-designated investment firms (collectively, banks). The proposals encompass a new senior manager's regime for directors and other senior individuals and a certification regime for more junior employees (collectively, 'SM and CR'). Alongside these changes will sit new conduct rules issued by both the FCA and PRA that will regulate individuals' behaviour. These two regimes will replace the current approved person's regime and statements of principle and code of practice for approved persons.

The proposals build on recommendations made by the Parliamentary Commission on Banking Standards (PCBS) in its report Changing Banking for Good published in June 2013. In short, PCBS found that under the current regime, there was little prospect of effective enforcement against individuals, mainly because too narrow a range of individuals were covered and responsibilities were not in practice attributed to individuals. The Financial Services (Banking Reform) Act 2013 (the Act) contains the framework for the new regime.

On 17 November 2014, HM Treasury, in exercise of its powers under the Act, issued its own consultation in the area aimed at widening the scope of the new regime to capture personnel within UK branches of overseas banks. More recently and in response to concerns raised by industry during the consultation period for the Joint Paper about the proposed approach to non-executive directors (NEDs) under SM, FCA and PRA published a second joint consultation paper with FCA in particular revising its approach to NEDs. On 3 March 2015, it was announced that SM and CR will start on 7 March 2016 and that the regimes would also apply to UK branches of foreign banks from that date.

Senior managers regime

The Joint Paper proposes a new approval regime for senior managers whose actions and decisions would have a significant impact on the banking sector and customers which will replace the significant influence function element of the approved person's regime. Broadly, this will include the bank's board of directors; executive committee members (or equivalent); heads of key business areas that satisfy certain criteria; individuals who are responsible for important business-, control-, or conduct-focused functions within the bank; and those individuals employed by a group or parent company who exert significant influence over the bank's decision making. As regards NEDs, PRA proposed to require pre-approval only in relation to NEDs with specific responsibilities as senior managers, the Chairman, chairs of the Audit, Remuneration and Risk Committees and the senior independent director. In contrast, FCA proposed to capture all NEDs not otherwise approved by PRA (Standard NEDs). In response to the consultation, FCA agreed that including Standard NEDs and therefore applying the presumption of responsibility could encourage them to become more "executive" contrary to their purpose as independent members of the board and FCA dialed down its approach requiring approval only for the Chair of the Nomination Committee and the PRA non-executive functions. Accordingly, Standard NEDs will not be included in the SM and therefore not subject to pre-approval or the presumption of responsibility.

Individuals who perform a senior management function specified by PRA would require pre approval by PRA with FCA's consent; where the function is FCA specified, pre approval by FCA only will be required. The application to the FCA or PRA for approval must be accompanied by a statement of responsibilities that sets out the areas of the bank for which that individual will be responsible. The statement is a vital part of the approval process and must be resubmitted to the relevant regulator whenever there is a "significant change" in the individual's responsibilities. The Act empowers FCA/PRA to impose conditions and time limits on senior manager approvals. It bears emphasizing that these statements will be more wide-ranging and sophisticated than a job description. The regulators expect that statements will be an important tool for supervising senior managers and assessing overall corporate governance of banks. As part of the transition, individuals who are currently approved persons and covered by the SM will be "grandfathered" into it.

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Certification regime for junior employees

The Joint Paper also includes a certification regime, which will apply to employees who are not subject to the SM but who still perform a role related to regulated activities and can therefore cause significant harm to the bank or its customers. For PRA, the certification regime will apply to material risk-takers, and for the FCA, it will apply to those in customer-facing roles, individuals who supervise certified persons, and any other role not covered by the SM, such as benchmark submitters. Senior managers will be responsible for the assessment and certification of the relevant junior employees and be required to assess their fitness and propriety annually, which will involve banks in significant due diligence.

Conduct rules

The Joint Paper proposes a set of conduct rules that would apply not only to all senior managers and their respective populations within the certification regime but also to all other bank employees, except those who carry out purely ancillary functions (a wider group than employees subject to the certification regime). The FCA and PRA have each proposed their own set of substantially similar rules, which, happily, largely draw on current rules.

The rules are split into two tiers. Tier One, the Individual Conduct Rules, apply to all roles in which individuals are subject to the two new regimes described above. Tier Two, the Senior Manager Conduct Rules, apply merely to those covered by the SM (in addition to Tier One).

Responsibilities map

The FCA and PRA propose to issue rules and guidance requiring banks to prepare, maintain and update a responsibilities map that describes the bank's management and governance arrangements, setting out how responsibilities have been allocated, whether they have been allocated to more than one individual, reporting lines, and an organisational structure. A main concern is to ensure that overall the allocation of responsibilities to a given bank's senior managers (as set out in their respective Statements of Responsibilities) does not leave any gaps in accountability. Indeed, the bank's board will be required to give an annual confirmation to the regulators that there are no such gaps.

Fitness and propriety

The Act obliges banks to establish that candidates for senior manager or certification functions are fit and proper to perform the role for which they are applying and thereafter to make annual assessments of such, to report senior managers who fail that assessment to the regulators, and to refuse to renew the certificate of employees who fail that assessment. There is already FCA guidance on assessing fitness and propriety, and FCA proposes to continue with that. PRA will produce its own guidance, but its underlying substance is not expected to change.

Enforcement

On enforcement, if a bank contravenes a relevant requirement, the burden of proof is reversed so that the senior manager responsible for the area where the contravention has occurred could be held accountable if they are unable to satisfy FCA and PRA that they have taken "reasonable steps" to prevent or stop the breach, the so-called "presumption of responsibility". The Act allows FCA and PRA to take disciplinary actions for breach of conduct rules against a much broader range of bank employees than under the current regime. This should enable FCA and PRA to pursue wrongdoing wherever it is found.

Furthermore, senior managers who work in UK-incorporated banks, building societies, and PRA-designated investment firms face potential criminal liability under a new offence relating to a decision causing a financial institution to fail, which will come into force from March 7, 2016. HM Treasury has decided not to make senior managers of UK branches of overseas banks subject to that offence.

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