Implementing the recommendations of the Parliamentary Commission on Banking Standards: Government Response to the Committee’s Seventh Report of Session 2014–15

Third Special Report of Session 2014–15

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Third Special Report

The Treasury Committee published its Seventh Report of Session 2014–15, Implementing the recommendations of the Parliamentary Commission on Banking Standards, on 28 October 2014, as House of Commons Paper 768. The Government Response was received on 19 January 2015 in the form of a letter from Andrea Leadsom MP, Economic Secretary, HM Treasury. It is attached as an appendix.

Appendix: Government Response

Letter from Andrea Leadsom MP, Economic Secretary, HM Treasury, dated 19 January 2015

I am writing to you with regard to the Statement published on 17 November 2014 by the former members of the Parliamentary Commission on Banking Standards (PCBS), a body that you chaired. This Statement accompanied the Treasury Committee report on implementation of the PCBS’s recommendations.

The government welcomes these publications. We agree that a great deal of progress has been made since the Commission’s final report and that it is essential that momentum is maintained in implementing the UK’s financial services reforms. The Treasury Committee’s report is a comprehensive reminder of the amount of incredibly productive work undertaken by the PCBS itself, this government, both Houses of Parliament and the regulatory authorities. This work was necessary, and will continue through implementation and reviews, both ongoing and upcoming.

In this response to the Statement of the former members, the government is setting out its thoughts on conclusions as appropriate. The government notes the issues raised which are directly for the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to consider and take forward in their respective roles.

Ring-fencing, resolution and proprietary trading

The government welcomes the views of the former members of the PCBS on ring-fencing, with its consideration of electrification, the forthcoming review and ongoing implementation. On ‘electrification’ specifically, the government has implemented the changes suggested by the PCBS, having "electrified" the ring-fence by giving the PRA a power to initiate the breaking up of a banking group subject to ring-fencing with HM Treasury’s consent. The government agrees with the virtues of an independent review of ring-fencing after the regime has come into force.

The government notes that the Statement welcomes the work proposals for secondary legislation. This legislation, and its implementation, is required to ensure successful ring-fencing and the government remains on track to have all ring-fencing legislation in place.
by the end of this Parliament in 2015. The government supports the ongoing work being carried out by the PRA to implement ring-fencing, including the work being done, for example on the structure of ring-fenced banks, and the work that will be done, for example on setting restrictions on financial transactions between ring-fenced banks and other group members. When designing and introducing rules the PRA will look to minimise or prevent any risks that could present a serious challenge to the stability of ring-fenced banks.

Moving on to the Statement’s conclusions around “crucial” resolution measures, the government is pleased to report on the significant progress since the Commission published its final report. The government has introduced reforms to implement the European Bank Recovery and Resolution Directive—most importantly, by amending the bail-in powers in the Financial Services (Banking Reform) Act 2013 to ensure full consistency with the Directive. This ensures that all EU banks are subject to a common set of resolution powers, and the same conditions and safeguards on the use of those powers.

The government fully supports the outcomes of the G20 summit in Brisbane in November 2014, where leaders agreed proposals for an international standard on total loss-absorbing capacity (TLAC) for global systemically important banks (G-SIBs). The FSB will now undertake comprehensive impact assessment studies to inform the calibration of the requirement, with a commitment to finalise the proposal by the next G20 Leaders’ Summit in 2015.

As the conclusions accurately note, cooperation between authorities is a key part of ensuring that resolution is achievable for large, cross-border banks. Recognising this, the FSB continues to prioritise cooperation between authorities—through the formation of crisis management groups; and the development of institution-specific cooperation agreements. In addition to this, work continues to ensure that authorities can recognise and support resolution actions taken by foreign authorities.

The government strongly welcomes the work undertaken so far, and while we acknowledge the views of the former members, we believe the international community is on track to ensure the resolution regime will be effective and positioned to pass future tests.

The government agrees with the conclusions around the need for cooperation between banks and the regulators in drawing up resolution plans. It is for this reason UK banks are required to cooperate with the authorities in the development of resolution plans, and with the Bank of England in planning to exercise, or in actually exercising, any of its resolution powers.

We note the views expressed in the conclusions on proprietary trading. The government agreed with the PCBS about the potential risks around this issue and took forward that support through the legislation outlined in the Statement.
New regulatory regimes for individuals

The government broadly accepted the conclusions of the final PCBS report and as a result made changes to the legal framework (mainly amendments to Part 5 of the Financial Services and Markets Act 2000) in the Financial Services (Banking Reform) Act 2013, which received Royal Assent in December 2013.

Since then the government, the PRA and the FCA have been working on the detailed measures (secondary legislation and regulatory rules) to implement the reforms, this work will be completed in 2015.

Specifically with regard to the scope of the ‘Senior Managers Regime’ (SMR), the government agrees that the correct way to adjust the scope of the criminal sanction is through adjusting the coverage of the SMR. The SMR is intended to cover those responsible for managing a bank and it is appropriate therefore that the criminal sanction should also potentially apply to them. The government recognises the concerns about the inclusion of non-executive directors (NEDs) in the SMR, but it notes that NEDs are full members of a company’s board and can be involved in critical decisions affecting its future. In addition, as stated by the conclusions, issues around scope and responsibilities will be taken forward by the regulators and their work in this area is welcomed.

The government notes the conclusions on the scope of the Certification regime and the role of banks within it, and leaves this issue to the regulators as legislated. Similarly, there is a need for meaningful rules in the area of conduct, however it is ultimately for the regulators to determine them and then to revise or review them as necessary.

The government also notes conclusions in respect of the extension of the SMR to the rest of the financial services industry, and the abolition of the Approved Persons Regime. This is being considered as part of the Fair and Effective Markets Review. Further primary legislation would be needed to extend the SMR (and the Certification Regime) to the financial services industry outside banking. The government agrees that, if this proposal were taken forward, it would be appropriate to consider how these regimes should be applied outside banking, and also to learn lessons from their application to banking.

Remuneration

The government and regulators broadly endorsed the conclusions of the PCBS with regard to remuneration and the regulators stated their intention to consult on a revised Remuneration Code in 2014. We worked closely with the PRA and FCA in the lead up to their July 2014 consultation on this topic.

1 See sections 36 to 38 of the Financial Services (Banking Reform) Act 2013.

2 The government has the power to extend the Senior Managers Regime and the Certification Regime (but not the criminal sanction) to UK branches of foreign credit institutions and investment firms by statutory instrument. The Treasury issued a consultation on this on 17 November 2014.
On **clawback**, following its consultation we welcome the PRA’s regime whereby vested bonuses can be clawed back in certain circumstances. These rules are now in place, and bonuses can now be clawed back for seven years after they are awarded.

As regards conclusions on **deferral**, and the Statement’s view that deferral periods could be lengthened, this government is supportive of measures to ensure the reduction of incentives to take excessive risk, and measures such as deferral have been a key instrument in restructuring remuneration. We welcome the work of the regulators in this area following our instructions that they consult on this issue, and it was their July 2014 consultation that proposed deferral of no less than five years (seven years for Senior Managers), vesting at a pro rata rate to avoid front-loading, and for Senior Managers, no vesting for at least three years. The consultation also noted that the regulators feel they already have adequate powers under FSMA to require longer deferral if it was felt necessary for a particular firm.

The conclusions on **scope** recommend the application of the PCBS remuneration proposals beyond ‘material risk takers’ to a wider set of individuals. The rules in the proposed Remuneration Code reflect the government’s view that extending the scope would go significantly beyond international standards and could result in inappropriately strict regulation of the pay of relatively junior staff, and this is a view we maintain alongside the regulators. Our view is that the potential changes consulted on by the regulators to implement PCBS recommendations are prescriptive and appropriate only for individuals whose actions may have a material impact on the risk profile of a firm.

With respect to payments to bailed out banks and the stated view that the regulators should "go further" than their July 2014 consultation, this is a matter for the regulators to take forward. The government agreed with the PCBS recommendation for the introduction of regulatory power to void or cancel entitlements for certain discretionary payments for banks receiving direct taxpayer support and as a result we asked the PRA to consider what more could be done in this area.

This government strongly believes there should be no rewards for failure in the banking sector, and will keep the regulators’ power under review in this regard to ensure their adequacy.

**Competition**

With respect to **regulation and competition**, the government agrees with the Statement, it being essential that the financial regulators treat competition in banking markets as a priority. That is why the government provided the FCA with both a statutory competition objective and a duty as part of its remit, and accepted the PCBS’s recommendation the PRA also be given a secondary competition objective. In addition to providing the PRA with this competition objective, the Banking Reform Act 2013 also gave the FCA strong additional powers on competition and created a new Payments...
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Systems Regulator, which will look at competition issues concerning access to payments. Both the FCA and PRA have already taken action on competition, including by lowering barriers to entry for new and smaller banks, and are required to report against their competition objective as part of their annual reporting. We also note the suggestions that Parliament should be alert to risks of regulation on competition.

These changes are only part of a wide-reaching programme of reforms that have been implemented by the government to make the banking sector more competitive so individuals and businesses get a better deal. This includes measures to support competition and switching in current accounts, such as a Current Account Switch Service to give consumers the power and confidence to vote with their feet; and new legislation through the Small Business, Enterprise and Employment Bill to improve competition in the provision of finance to smaller businesses.

However, competition issues in key retail banking markets are longstanding and there remains work to be done. That is why the government welcomed the Competition and Markets Authority’s (CMA) decision to progress with market investigations into both current accounts and SME banking. The CMA was created by this government to take forward high-impact work such as this.

Moving on to basic bank accounts and the views set out in the Statement, this government believes that it is vital that banks offer products which are suitable for day-to-day transactions for all consumers. In December, the government announced the conclusion of a significant process of negotiation with nine major current account providers to provide new basic bank accounts by the end of 2015, including a commitment to remove unpaid item fees and prevent unauthorised overdrafts and overrunning. Accounts will be available to anyone who doesn’t already have a bank account or who cannot use their existing account due to financial difficulty. Basic bank account customers will now also be offered services on the same terms as other personal current accounts that the banks provide, including access to all the standard over-the-counter services at bank branches and at the Post Office, and access to the LINK ATM network. The terms of the agreement have been published online[3] so that customers and consumer groups have a clear understanding of what they can expect from the participating banks and building societies.

**Better regulation**

The Treasury has completed its review of enforcement decision-making at the regulators, and published its report on 18 December. The review expressly considered issues raised by the PCBS and stated here in the conclusions, including those on a further decision-making body and issues around the burden of proof.

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Recommendations were made to ensure that cases are only referred for enforcement investigation where that is considered to be the right regulatory response, following consideration of appropriate, alternative supervisory responses by senior regulators.

The review also concluded that the PRA’s executive-led decision-making model did not offer the perception of functional independence and objectivity necessary in contested cases. The creation of an independent PRA enforcement decision-making committee, with a senior legal chair, was therefore recommended.

There was strong support in consultation for the FCA Regulatory Decisions Committee (RDC). That is partly why the review did not favour the creation of a specific, banking RDC for FCA and PRA cases, as called for by the PCBS. However, the review also considered that, given the regulators’ distinct statutory objectives and areas of regulatory focus, their decision-makers were likely to require expertise in different areas. The review also found merit in each regulator retaining discretion to design their own processes to meet their respective strategic and operational requirements.

Nevertheless, the review made recommendations to ensure annual reporting by the regulators’ decision-making committees, and parliamentary accountability for the chairs, if the Treasury Committee wishes it. It also recommended that the regulators put in place a clearly sign-posted, expedited procedure to enable the subjects of enforcement decisions to access the Upper Tribunal directly, if they prefer to challenge enforcement cases in a tribunal environment, where they can call oral evidence and cross-examine witnesses.

The government found that full cooperation between the supervision and enforcement regulatory functions was critical, and that institutional separation of those functions would be likely to imperil that cooperation. That is because distinct organisations with different objectives and divergent priorities would impair the identification of the right regulatory response, both in specific cases, and in respect of wider, emerging risks.

A further recommendation in the report is that the contested case decision-makers should regularly review the regulators’ processes in settled cases. In doing so, the decision-makers should seek comments from all, or a sample of those who have settled FCA and PRA enforcement cases, and speak with the relevant enforcement staff. The decision-makers will be able to monitor the effectiveness of the recommended changes to the settlement process, identify process lessons and make generic, public recommendations, to ensure that the process continues to function effectively.

The enforcement review recommends that the regulators should consult on, and issue clear guidance in respect of the application of the reverse burden of proof in due course. However, it is the government’s view that it is premature to consider whether additional scrutiny may be necessary. Subjects already have unfettered access to the Upper
Tribunal, and the recommendations of the enforcement review will promote more direct access where subjects prefer to challenge the regulator in that venue. Moreover, taken together, the recommendations will generally help to ensure fairness and accountability in enforcement decision-making by the regulators.

The government notes the issues raised on mis-selling at the point of sale and agrees on the potential consequences around retrospective interpretation of rules. We look forward to seeing the outcomes of the FCA’s work in this area.

The government agrees with conclusions on leverage ratio requirements, and believes that the Financial Policy Committee (FPC) is best placed to make decisions on this issue. The government notes that the calibration put forward by the FPC means that leverage ratio requirements would be a supplement to, not a replacement for, existing risk-weighted capital ratio requirements. We also share the view that the FPC should exercise its judgement as outlined, financial stability need not come at the price of a material restriction in the ability of the financial sector to contribute to economic growth, and it is enshrined in the operational objectives of the FPC that it must pursue financial stability in support of the economic objectives of the government.

On regulatory accounts, the government supports the work of the International Accounting Standards Board and its long term goal of a single set of high-quality accounting standards. We similarly look forward to seeing the outcomes of the Bank of England’s consultation, which will need to have a firm grounding in cost-benefit analysis.

The government welcomes the former members’ continuing interest in regulatory fees and the cost of regulation, and notes the role of the Treasury Committee in monitoring and scrutinising the regulators’ ongoing operating costs.

The conclusions on the ongoing HBOS review are noted. The government welcomes the work the PCBS had previously done to shed light on the factors that contributed to HBOS’s failure and the subsequent need for government intervention, and looks forward to the publication by the FCA and PRA of their inquiry into the failure of the HBOS.

We believe that the work undertaken, alongside the work in hand, is comprehensively addressing problems with banking standards that have done so much to undermine society’s faith in the banking system.

The government is grateful to the PCBS, and to you as its Chairman, for its important contribution to this extensive and necessary work, in terms of its hugely intensive reporting and also the guiding hand that it placed on the development and implementation of measures that will enhance the soundness and stability of the
banking sector. The (Financial Services) Banking Reform Act 2013 would have taken a very different shape in the absence of the PCBS and its input endures.