A Misconduct

Misconduct imposes costs on society at large and has undermined trust in banks and financial markets, reducing the effectiveness of the financial system. Banks and the financial sector have primary responsibility for addressing these issues. The FPC supports the steps being taken by national and international authorities to address the root causes of misconduct including the recommendations of the Fair and Effective Markets Review in the United Kingdom and the work programmes announced by the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO). The FPC continues to take a forward-looking assessment of misconduct costs in its capital assessments and stress testing of the UK banking system.

Misconduct by banks has been widespread and costly…
Over the past six years numerous examples of misconduct by banks and their employees have been uncovered (**Table A.5**). Since 2009, UK banks have paid almost £30 billion in fines and redress costs (**Chart A.28**), roughly equivalent to the private capital they have raised in the same period. Banks may have incurred further costs for households, companies and governments through attempted manipulation of financial market benchmarks.

Table A.5 Examples of misconduct by banks and their employees

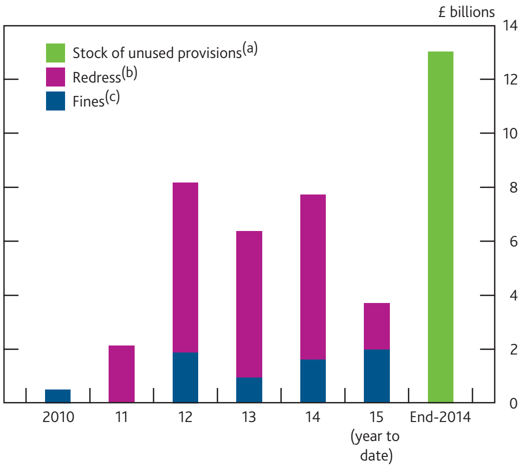
Mis-selling of retail financial products such as payment protection insurance (PPI) to households and interest rate hedging products to companies.

Alleged mis-selling of wholesale financial products such as US residential mortgage-backed securities to financial institutions and investors.

Violation of rules, regulations and laws such as tax rules, anti-money laundering rules and economic sanctions.

Attempted manipulation of financial market benchmarks such as Libor, Euribor and foreign exchange fixes.

Chart A.28 UK banks have continued to incur costs related to past misconduct
Fines and redress payments incurred by UK banks



Sources: European Commission, FCA, *Financial Times*, firm submissions, FSA and Bank calculations.

(a) Major UK banks.
(b) For mis-selling PPI and interest rate hedging products, includes a small amount of redress paid by non-banks.
(c) Levied by US authorities, the FSA/FCA and the European Commission.

Assessing the costs of past misconduct is an ongoing process. In November 2014, the UK Supreme Court ruled in 'Plevin vs Paragon Personal Finance Ltd' that a failure to disclose a large commission payment on a payment protection insurance (PPI) policy made the relationship between a lender and the borrower unfair.[1] In response, the FCA is considering whether additional rules and/or guidance are required to deal with complaints about PPI. UK banks further face civil litigation by private investors regarding allegations of misconduct, and are subject to a number of investigations by authorities internationally.

Reflecting these uncertainties, UK banks held significant provisions at end-2014 (**Chart A.28**). Potential future costs related to past misconduct will be assessed as part of the 2015 stress test of the UK banking sector (Box 3).

…undermining the effectiveness of the financial system.
The costs to society of misconduct may be larger than the direct costs to customers and banks, particularly where it has impaired the effectiveness of the financial system. For example, in the run-up to the financial crisis, alleged mis-selling of US residential mortgage-backed securities contributed to excessive lending to sub-prime borrowers.

(1) See Supreme Court press summary; www.supremecourt.uk/decided-cases/docs/UKSC_2014_0037_PressSummary.pdf.

Mistrust between market participants, or of market benchmarks, can also impair the functioning of specific markets. And according to the *SME Finance Monitor*, in 2015 Q1, 75% of UK small businesses remained reluctant to borrow from banks. This is most likely to reflect economic conditions, but intelligence from the Bank's Agents suggests that it was also partly due to distrust of banks among smaller companies.(1)

Non-financial sanctions, such as restrictions on undertaking certain activities, are an essential supervision and enforcement tool. Where there are substitute providers, the wider impact of these actions should be limited. But if misconduct is widespread, non-financial sanctions could affect a significant proportion of a market, causing systemic risks. This issue is further explored in a report of the European Systemic Risk Board.(2)

To contribute fully to prosperity, banks and markets require a 'social licence' — the consent of society to operate and innovate.(3) That requires fairness and accountability. An erosion of trust and loss of social licence risks the imposition of rules or restrictions on banks and markets that are detrimental to their contribution to prosperity.

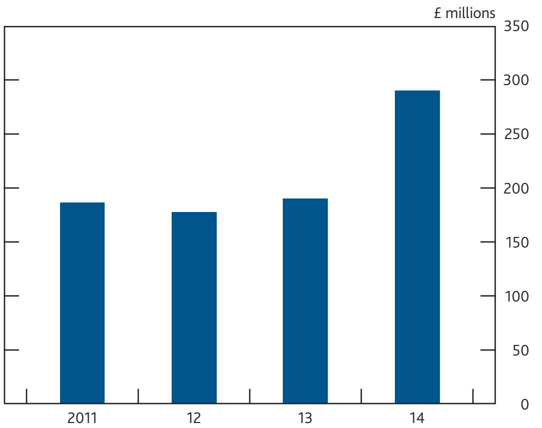
Steps have been taken to strengthen accountability…

Following the changes introduced by the Financial Services (Banking Reform) Act 2013, the PRA and the FCA have developed a Senior Manager Regime and a Certification Regime that will support a change in culture in banks, building societies, credit unions and PRA-designated investment firms. These regimes come into force on 7 March 2016. As part of the Senior Manager Regime, firms will be required to allocate specific responsibilities to the most senior individuals in banks.(4) If there is a regulatory breach by a firm, there will be a statutory requirement on the relevant Senior Manager to satisfy the PRA/FCA that (s)he took reasonable steps to prevent it. Failure to do so may subject the Senior Manager to regulatory sanctions, ranging from fines to a prohibition order. The Certification Regime, meanwhile, will require relevant firms to certify annually the fitness and propriety of employees who could pose a risk of significant harm to the firm or any of its customers.

The PRA and the FCA have also developed new enforceable 'Conduct Rules', to apply to Senior Managers and individuals in scope of the Certification Regime. The FCA will apply these

Chart A.29 Bonuses have been reduced to reflect past misconduct

Total reductions to unpaid deferred bonuses (malus) by major UK banks(a)



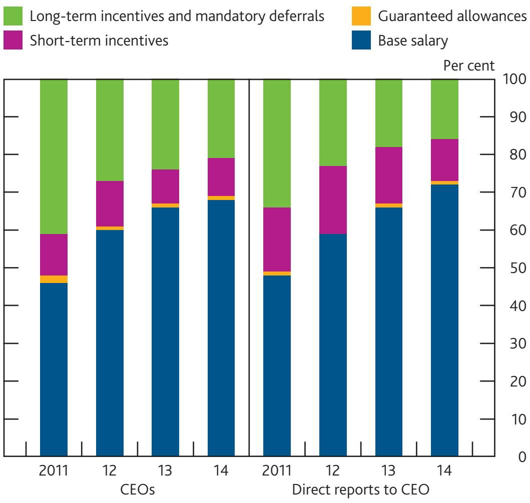
Sources: Published accounts — Barclays, HSBC, Lloyds, RBS and Standard Chartered.

(a) Excluding figures for individuals who resigned or had their contracts terminated.

(1) *Agents' summary of business conditions*, February 2015; www.bankofengland.co.uk/publications/Documents/agentssummary/2015/feb.pdf.
(2) See 'Report on misconduct risk in the banking sector', June 2015; www.esrb.europa.eu/pub/pdf/other/150625_report_misconduct_risk.en.pdf.
(3) See 'Building real markets for the good of the people', June 2015; www.bankofengland.co.uk/publications/Pages/speeches/2015/821.aspx.
(4) For the complete list of PRA prescribed responsibilities, see Table A on page 6 of *PRA Policy Statement PS3/15*, 'Strengthening individual accountability in banking and insurance — responses to CP14/14 and CP26/14', March 2015; www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps315.pdf.

Chart A.30 Bonuses have been falling as a share of total pay

Compensation structure of CEOs and direct reports to CEOs of major banks operating in the European Union[a]



Sources: Published accounts — Barclays, HSBC, Lloyds, RBS and Standard Chartered.

(a) Excluding figures for individuals who resigned or had their contracts terminated.

Table A.6 FEMR: root causes of misconduct in FICC markets

- **Market structures** that presented opportunities for abuse.
- **Standards of acceptable market practices** that were sometimes poorly understood or adhered to, short on detail or lacked teeth.
- **Systems of internal governance and control** that placed greater reliance on second and third lines of defence than on trading or desk heads and failed to ensure that conduct lessons learned in one business line were fully applied elsewhere.
- **Limited reinforcement of standards through bilateral market discipline.**
- **Remuneration and incentive schemes** that stressed short-term returns over longer-term value enhancement and good conduct.
- **A culture of impunity in parts of the market**, coloured by a perception that misconduct would go either undetected or unpunished.

Table A.7 FEMR: steps already taken to address root causes of misconduct

- The design and oversight of many key FICC benchmarks has been overhauled.
- Transparency in some FICC markets has improved, and is likely to improve further over time, reflecting a range of regulatory and technological changes.
- The FCA has been given new powers which enable it to enforce against breaches of competition law.
- Some standards of market practice have been clarified or strengthened.
- The framework for ensuring remuneration is aligned with risk has improved significantly through the work of the FSB.
- Substantial efforts have been made to improve firms' internal governance, accountability and control structures.
- Individuals' perceptions of the probability that misconduct will be detected, and the scale of punishment, has increased.

rules to all employees except ancillary staff. The rules require covered individuals to act with integrity, due skill, care and diligence and be open and co-operative with regulators.

...and align incentives.

The PRA and the FCA have further strengthened rules on remuneration, aiming to align risk and reward.[1] In particular, the deferred portion of variable awards, which is up to 60%, must now be deferred over seven years for the most senior management and five years for other senior risk-takers. The previous minimum deferral period was three years. Since 2010, the major UK banks have applied malus (deductions from unvested deferred variable remuneration) on individuals implicated in misconduct (**Chart A.29**). Banks have also made significant deductions from their firm-wide bonus pools in respect of notable risk management failures. The PRA and the FCA further expect firms to use clawback of vested variable remuneration when appropriate.

Recent data suggest that fixed pay (salaries and certain types of allowance) is forming an increasing proportion of total pay for major banks operating in the European Union, including UK banks, with an accompanying fall in the proportion of variable pay (bonuses and long-term incentive plans) (**Chart A.30**). This may weaken the incentive effects of remuneration rules.

More reforms are needed in financial markets.

The Fair and Effective Markets Review (FEMR),[2] published on 10 June 2015, reviewed misconduct in Fixed Income, Currency and Commodities (FICC) markets. It highlighted a number of root causes in particular markets and business models (**Table A.6**), noting that substantial progress had been made in identifying and addressing many of them (**Table A.7**). However, FEMR also identified a number of gaps that current reforms do not tackle and made a number of recommendations (see Box 2). These include principles to develop fairer and more effective FICC market structures, and identify and mitigate new or emerging risks.

The United Kingdom is also playing a leading role in shaping international conduct standards. The FSB is developing approaches that can mitigate conduct risks through improved market organisation, structure and behaviour of market participants, and making sure enforcement actions remain credible. An important aspect of this agenda is the IOSCO work programme on conduct in securities markets. The FPC supports the steps that are being taken to address the root causes of misconduct including the recommendations in FEMR and the work programmes announced by the FSB and IOSCO. The FPC continues to take a forward-looking assessment of misconduct costs in its capital assessments and stress testing.

(1) See *PRA Supervisory Statement SS27/15*, 'Remuneration', June 2015; www.bankofengland.co.uk/pra/Documents/publications/ss/2015/ss2715.pdf.
(2) Fair and Effective Markets Review, Final Report, June 2015; www.bankofengland.co.uk/publications/Pages/news/2015/055.aspx.

Box 2
FEMR policy recommendations

Near-term actions to improve conduct in FICC markets:

1 Raise standards, professionalism and accountability of individuals

a. Develop a set of globally endorsed common standards for trading practices in FICC markets, in language that can be readily understood, and which will be consistently upheld;

b. Establish new expectations for training and qualifications standards for FICC market personnel, with a requirement for continuing professional development;

c. Mandate detailed regulatory references to help firms prevent the 'recycling' of individuals with poor conduct records between firms;

d. Extend UK criminal sanctions for market abuse for individuals and firms to a wider range of FICC instruments; and

e. Lengthen the maximum sentence for criminal market abuse from seven to ten years' imprisonment.

2 Improve the quality, clarity and market-wide understanding of FICC trading practices

a. Create a new FICC Market Standards Board with participation from a broad cross-section of global and domestic firms and end-users at the most senior levels, and involving regular dialogue with the authorities, to:

- Scan the horizon and report on emerging risks where market standards could be strengthened, ensuring a timely response to new trends and threats;
- Address areas of uncertainty in specific trading practices, by producing guidelines, practical case studies and other materials depending on the regulatory status of each market;
- Promote adherence to standards, including by sharing and promoting good practices on control and governance structures around FICC business lines; and
- Contribute to international convergence of standards.

3 Strengthen regulation of FICC markets in the United Kingdom

a. Extend the UK regulatory framework for benchmarks to cover seven additional major UK FICC benchmarks — accepted and implemented by HM Treasury on 1 April 2015;

b. Create a new statutory civil and criminal market abuse regime for spot foreign exchange, drawing on, among other things, work on a global code (see recommendation 4a);

c. Ensure proper market conduct is managed in FICC markets through monitoring compliance with all standards, formal and voluntary, under the Senior Managers and Certification Regimes;

d. Extend elements of the Senior Managers and Certification Regimes to a wider range of regulated firms active in FICC markets; and

e. Improve firms' and traders' awareness of the application of competition law to FICC markets.

4 Launch international action to raise standards in global FICC markets

a. Agree a single global FX code, providing: principles to govern trading practices and standards for venues; examples and guidelines for behaviours; and tools for promoting adherence. The Review strongly welcomes the recent announcement by central banks to work towards those goals;

b. As part of that work, improve the controls and transparency around FX market practices, including 'last look' and time stamping;

c. Explore ways to ensure benchmark administrators publish more consistent self-assessments against the IOSCO Principles, and provide guidance for benchmark users; and

d. Examine ways to improve the alignment between remuneration and conduct risk at a global level.

Principles to guide a more forward-looking approach to FICC markets:

5 Promoting fairer FICC market structures while also enhancing effectiveness, through:

a. Improving transparency in ways that also maintain or enhance the benefits of diverse trading models, including over-the-counter;

b. Promoting choice, diversity and access by monitoring and acting on potential anti-competitive structures or behaviour; and

c. Catalysing market-led reform held back by private sector co-ordination failures.

6 Forward-looking conduct risk identification and mitigation, through:

a. Timely identification of conduct risks (and mitigants) posed by existing and emerging market structures or behaviours;

b. Enhanced surveillance of trading patterns and behaviours by firms and authorities; and

c. Forward-looking supervision of FICC markets.