



BANK OF ENGLAND

Speech

Financial institutions supervision and culture

Remarks given by

James Proudman, Executive Director UK Deposit Takers Supervision

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'Reforming Culture and Behaviour in the Financial Services Industry'

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I would like to thank Richard Bennett for his invaluable contribution to preparing these remarks

Thank you very much for inviting me to take part in today's panel. It is a privilege to be here today at the New York Fed, and it is a privilege to be joining Kevin and my distinguished panellists to discuss the important topic of the role of culture in financial institutions supervision.

I'd like to begin by outlining why culture matters for banking supervisors such as myself. The key point is that the way in which decisions about risk are taken within firms – the “who, where and how” – clearly matter significantly to prudential supervisors. Past financial crises demonstrate that banks have been undermined by the excessively risky decisions that they had taken, sometimes years previously.

A firm's culture – the set of social norms that guide patterns of behaviour – clearly can affect decision making. Responsibility for culture has to rest squarely with firms themselves. A firm's culture is hard to describe precisely or pin-down, and evolves over time. And it is extremely hard, if not impossible, to either prescribe or supervise. Andrew Bailey, the former CEO of the PRA and now CEO of the FCA, summed it up nicely in his May 2016 speech when he said that a supervisor cannot ask a firm to “show us your culture”. But we can sometimes recognise a poor culture when we see it - whether it emanates from the ‘tone from the top’ or in the tell-tale signs, such as the behaviours that employees see rewarded in their bosses.

We strongly support industry initiatives which seek to build good practice. One such industry initiative is the work done in the UK by the Banking Standards Board (BSB) - as described by Baroness O'Neil earlier today, and Alison Cottrell, the CEO of the BSB later on this afternoon - which seeks to promote high professional and ethical standards in the banking industry. This and other industry efforts underscore the potential for professional bodies to play a role in raising levels of competence and ethical behaviour. In parallel with initiatives to improve culture within firms, there have been recent initiatives to strengthen market integrity. These initiatives recognise that firms cannot exist in isolation of the markets in which they operate, and neither can their culture be entirely insulated from developments elsewhere.

While responsibility for culture rests with firms, what regulation can do is provide a framework to improve decision making; I want to highlight two initiatives that have been central to our approach at the Prudential Regulation Authority and that we are now implementing; on individual and collective responsibility – the “who and where” – and on incentives – the “how” decisions are taken.

One lesson of the recent financial crisis was that, too often, senior staff in failing banks were able, either at the time or in retrospect, to deny responsibility for decisions taken within the firm. There was no answer to the question “who's in charge?”. Ensuring there is a clear and transparent answer to this question has been a priority of the prudential reform agenda in the UK.

The new Senior Managers Regime (SMR) came into force on 7 March and is aimed at clearly allocating responsibilities to individuals. The focus of the regime is on the small handful of most senior decision-makers, including executive and some non-executive directors. We require firms to set out for us simply and clearly - and not using a dictionary of legalese – what their responsibilities are, so that the PRA and FCA know, in advance of any problem arising, that responsibilities for the key activities of a firm are allocated to a senior individual. Senior Managers are subject to a statutory duty of responsibility that allows the PRA and FCA to hold them to account for misconduct if a regulatory breach takes place and it can be demonstrated that they failed to take reasonable steps to prevent or stop it. But while this statutory duty provides a robust enforcement tool, as a supervisor, I primarily view the regime as a vehicle for promoting better decision making, and as a tool for supporting day-to-day supervision.

On 28 September, the PRA also introduced a series of requirements for regulated firms to provide employment references to one another in a mandatory template when hiring Senior Managers. The template includes information relating to the individual's conduct record, and fitness and propriety, and seeks to prevent the 'recycling' of individuals with poor conduct records throughout the industry, as has happened in the past.

One of the challenges we have received from firms is that the emphasis in the SMR on the individual undermines collective responsibility and governance. I do not agree with this view. Individual accountability and collective decision making are compatible and complementary. Collective decisions do not arise in a vacuum but are the product of a range of individual contributions.

Alongside the Senior Managers Regime, we have spelled out more clearly what we expect of board members collectively. Our guidance, for example, addresses issues such as the optimal number of independent directors, underscores the importance of appropriate succession planning and sets out our expectations for the local governance of significant subsidiaries. And we evaluate firms' corporate governance through periodic supervisory reviews, either in the form of full reviews or simpler case studies. Our focus is on both the design and, even more importantly, the effectiveness of the firm's arrangements, including how firm culture is created, embedded and overseen.

For firms where we consider governance to be weak, we have the ability to apply additional capital to cover the financial risks generated by that weakness. In order to create the right incentives to fix problems, our approach is to outline clear and measurable actions that, once we are content they have been sufficiently remedied by the firm, result in the removal of the capital charge.

Taken together, the reforms that we have undertaken with respect to both individual and collective responsibility are aimed at creating a regime in which the senior management of firms are now "on the hook" for the decisions taken within the firm: both the key strategic decision taken at senior management level, and the framework of delegations and decision-taking that cascades through the organisation.

Ensuring clear accountability has been a necessary step, but is not sufficient. “How” decisions are taken matter too. People respond to incentives, and inappropriate financial reward mechanisms have, throughout history, created incentives for inappropriate behaviour in banks. Remuneration policy is a key lever to strengthen the alignment between risk and reward. Enhancing EU remuneration requirements within our own rules, the PRA has introduced a longer deferral regime, in which a large proportion of the variable remuneration of those subject to the Senior Managers Regime now has to be deferred for seven years. We have strengthened our expectations of firms’ ability to withhold the payment of unvested deferred remuneration (‘malus’) and retrieval of variable remuneration that has already been paid (‘clawback’). We now have clawback rules which can bite for up to ten years from the date of award. And we have recently published rules that will enable malus and clawback to be applied to bought out awards, which should help to close the loophole whereby “rolling bad apples” move between firms to avoid the consequences of their actions.

We also strongly support the work of the Financial Stability Board to address compensation and misconduct – a consistent and coordinated approach across the G20 is essential if there is to be real change. The new guidance that the FSB will develop for firms and supervisors will be important in securing this consistency.

So, what are we finding in terms of industry trends? As with any significant regulatory change, the implementation of the Senior Managers Regime generated extensive debate. Ahead of its introduction, there were considerable industry concerns about the potential unintended consequences of the regime on areas such as board dynamics and the ability of firms to attract and retain talent, and about the enforcement regime.

The regime has only been in force for a little over half a year, so it is too early to make definitive statements about its effects. We are now however starting to see signs that some of the intended effects are beginning to emerge, while we have not seen the more dire warnings crystallising. Feedback we have received suggests that greater clarity around the responsibilities of key executives is helping to facilitate effective challenge by independent non-executive directors. We have also heard that the greater clarity has sharpened focus on governance structure and policy ownership. And we have picked up that there is heightened attention by firms on conducting appropriate due diligence on prospective candidates. In short, the early signs are promising. In due course, the PRA will be developing a framework for the evaluation of whether our initiatives on accountability and incentives are meeting their objectives, including their impact on firms’ cultures and, if appropriate, will consider possible optimisations.

The final aspect I would like to cover is how this focus on the industry is reflected within the Bank of England. As a central bank and a regulator, we consider it important to hold ourselves to comparable standards to those we require from regulated firms.

Since March, the Bank of England, including the PRA, has been applying the Senior Managers Regime to its own senior decision-makers. Each member of the Bank of England's senior leadership team, myself included, is covered, and the associated statements of responsibility are available to view on the Bank's website. Consistent with what we expect from the firms we supervise, these ensure that overall responsibility for each of the Bank's activities, business areas and management functions are allocated to a Senior Manager. We also plan to adopt enhanced employment reference requirements similar to those that will apply to PRA-regulated firms.