The net tightens

Oonagh McDonald examines how financial regulators in the UK and US are introducing tougher rules for bankers and stricter penalties for those responsible for corporate failures

Why have so few senior bankers gone to jail? This is the question posed by the public in the aftermath of the financial crisis both in the UK and, more widely, in the US. The proper response is: what for exactly? This is not to imply that some, perhaps many, senior bankers were not among those responsible, at least in part, for the near collapse of the global financial system. It does mean that the laws and regulations under which anyone is held to account must be clearly stated and should have been in force at the time of the alleged crime. It is worth looking at what rules were in force in the run-up to the financial crisis.

The senior managers regime was introduced in the UK in the mid-1990s, following the demise of Barings. Under that regime, it is possible to declare someone unfit to work in the financial services industry at any level. Although potentially a useful tool, it was not often applied. Worse, when an attempt was made to use it to oust Fred Goodwin, the chief executive of RBS, it was found to have few teeth.

The Financial Services Authority (now the Financial Conduct Authority) admitted that, with regard to Goodwin, it had "not identified any enforceable breaches of the FSA's rules and BIS's lawyers have not found anything under the Disqualification of Directors Act either". After public and parliamentary criticisms of the incident, the Prudential Regulation Authority and the FCA consulted widely about a stricter regime.

Now, following those consultations, senior managers will be subject to approval by the FCA and/or the PRA and this approval may come with conditions and/or time limits. The assessment of an individual's "fitness and properness" will have regard to his or her honesty, integrity and reputation, as well as to his or her competence, capability and financial soundness.

It will, according to European Banking Authority guidelines, include an interview process in which the proposed candidate's knowledge, experience and application of skills in previous occupations will be assessed, as well as other qualities and skills, such as "decisiveness, strategic vision, judgment on risks, leadership, independence of mind, persuasive power, and the ability and willingness to engage in continuous learning and development". The regime applies to the most senior executives responsible for overall business, financial resources, risk management, internal controls or any other fundamental business area. That means the chief executive, the chief financial officer, the chief risk officer, head of internal audit, group entity senior manager, and those responsible for compliance oversight and money-laundering reporting. Large banks also have certain senior management functions, such as the chair of the risk committee, chair of the remuneration committee and a senior independent director, who will also all come under the regulations.

> The old regulatory regime was found to have few teeth

The PRA and the FCA had initially proposed including a "presumption of responsibility" for senior managers but that will not now be in the Bank of England and Financial Services Bill, announced on 15 October. Instead the Bill introduces a "duty of responsibility". This was reported as the government going soft on bankers but the reversal was required by the Human Rights Act and the UK's long-established principles of justice. Everyone is deemed to be innocent until proved guilty – not the other way round.

Under the new regulations, each senior executive must provide a signed 300-word statement, according to a prescribed format, detailing the executive functions for which he or she is responsible. These statements must be resubmitted if there is any significant change in a senior manager's responsibilities and must be part of the company's managerial responsibilities map, which will set out detailed information about governance arrangements, including reporting lines and lines of responsibilities. The senior manager's defence remains the same: that although he or she was at the relevant time responsible for the management of certain of the bank's activities, he or she took all reasonable steps to prevent the breach of rules occurring or to ensure that, once the breach was discovered, it was stopped and remedial actions taken.

The regulators have increased their use of "attestations", a supervisory tool that involves a senior executive at a regulated company giving a personal guarantee that a certain action has or will be taken. This was introduced by the FSA after it had failed to bring successful enforcement actions against individuals.

The FCA intends to use it when a senior manager has given a guarantee that the regulator will be notified if an emerging risk has become more pronounced and that a specific action will be taken within a particular time-frame. The senior manager may then certify (self-certification) that the risks related to more significant issues have been resolved or mitigated, or may provide verification that this has happened, for example by internal audit.

The PRA document also sets out the factors that it would take into account in determining whether or not the senior manager had taken all reasonable steps to prevent the breach from happening. This would still include considering whether he or she had the necessary skills and competence to carry out his or her specific executive responsibilities, or the steps he or she could, or should, have taken at the time. The burden of proof would lie with the FCA and the PRA not the senior manager.

Where the tabloids may start to sit up and take notice is over the introduction of a new potential criminal liability. Under this, senior managers could become criminally liable if they were considered to have made a reckless decision causing a financial institution to fail. The senior manager concerned must either take, or agree to, a decision that causes the bank to fail and be aware at the time that there is a risk that the decision will cause that to happen. The manager has to be shown to have behaved in a way that falls far below what could be reasonably expected of a person in that position. It has to be demonstrated that he or she knew what the risks were, or could have been assessed to be, at the time.

The problem with this is that it may be difficult to disentangle what, are seen, with the benefit of hindsight, as obvious serious risks from the way they were seen at the time. In addition, in the Financial Services Banking Reform Act, 2013, the failure is narrowly defined in terms of an individual's decision as the cause of the failure of the bank. It will be interesting to see how cases brought under this part of the Act fare in the courts.

Given that what happens in any trial will help shape the law, regulations on accountability and enforcement in the UK are likely to continue to develop and change and this could have wider implications for financial services around the world. Senior banking regulators in the US, for example, are looking with interest at the tightening of the senior managers regime in the UK.

The deputy attorney-general at the US Department of Justice, Sally Yates, issued a memorandum in September that set out some of its stall. It stated that: "One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who have perpetrated the wrongdoing. Such accountability...deters future illegal activity, it incentivises changes in corporate behaviour, it ensures that the proper parties are held responsible for their actions and it promotes the public's confidence in our justice system."

Senior managers will have to provide a 300-word statement

The memorandum recognises the difficulties in demonstrating the culpability of high-level executives, "who may be insulated from the day-to-day activity in which the misconduct occurs". Until now, US banks accused of misconduct have reached deferred prosecution agreements with the authorities and paid hefty fines that made their problems go away – without any liability being laid at the door of executives. But the memorandum seems to represent a shift in intent. It makes it clear that, to qualify for credit for cooperating with the prosecution, banks must provide all the relevant facts about the people responsible for corporate misconduct. More importantly, the Department of Justice will not release culpable people from civil or criminal liability when resolving the matter with the bank concerned. The regulators are singing from the same hymn sheet.

What caused this change? For many years, prosecutors have accepted deferred prosecution agreements and fined banks, presenting it as "transforming the corporate culture". The transformation has plainly not taken place. The practice of deferred prosecutions was condemned in a recent article by Judge Jed Rakoff, of New York, who described the whole process as "technically and morally suspect because, under the law, you should not indict or threaten to indict a company unless you can prove beyond reasonable doubt that some managerial agent of the company committed the alleged crime; and, if you can prove that, why not indict the manager? And from a moral standpoint, punishing a company and its many innocent employees and shareholders for the crimes committed by some unprosecuted individuals seems contrary to elementary notions of moral responsibility."

Holding those responsible to account should be the principle underlying prosecutions and enforcement actions against banks. But even the pretence of improving the culture of banks seems to have been cast aside in the actions taken against them by the Federal Housing Finance Agency and the Department of Justice. Freddie Mac's CEO, Donald Layton, for example, referring to a $404m settlement between Freddie Mac and Bank of America on residential mortgages, said: "We continue to make very good progress in recovering funds that were due to the taxpayer, as well as resolving Freddie Mac's legacy repurchase issues." The latest estimate of the total fines imposed on US banks is $220bn by March 2015 (compared with the $187.5bn cost of bailing out Fannie Mae and Freddie Mac alone in September 2008).

The US is looking at adopting some of the UK requirements

Banking regulators in the US do not have recourse to a senior managers regime and, in general, they do not require senior managers to be approved before they are appointed, except when a bank applies for its charter. Thereafter, a troubled bank has to submit and obtain approval for changes in its business plan and fundamental changes in its leadership. US banking regulators have to supervise thousands of banks, ranging from small community ones to large, complex, global banks, which may stretch oversight resources. When it comes to serious violations of the law, they have similar powers to those of UK regulators in terms of removing, prohibiting and suspending people whose actions result in losses to the bank or financial benefit to themselves. But the figures suggest that comparatively few such enforcement actions are carried out each year, relative to the size of the US banking sector.

The UK regime may not be appropriate for all banks and would have to be adapted to the US situation. US officials have been briefed on UK developments and can see their merits. Mary Jo White, chair of the SEC, recently said: "What we do not have in the US... is real accountability for 'on your watch' offences…We are all focused on that…It would require legislative changes...The senior managers regime is a very intriguing set of changes." In speaking to compliance officers in July 2015, she emphasised their accountability but also said that enforcement actions would be taken in the case of significant misconduct or failures.

It is clear that US banking regulators are looking closely at the UK regime with a view to its possible adoption. In both countries there is a renewed commitment to a regulatory and enforcement focus on those bank employees and directors responsible for compliance failures. That leaves only two problems for regulators and legislators. Will stricter rules on personal liability deter well-qualified individuals from taking on executive or oversight roles? And can senior managers know what numerous and far-flung staff are actually doing?

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