



Seven Deadly Sins: 'Retrospectivity, Culpability and Responsibility'

Roger McCormick | April 2015

Introduction

It's fair to say that the general reputation of the banking sector remains very low in 2015 even though some years have now passed since the global financial crisis. As our Conduct Costs Project has shown, the level of fines and other "conduct costs" suffered by major international banks has reached extraordinary proportions. And, in addition to fines and compensation, the public response to conduct failings ranges from demands for prison sentences, resignations and public humiliation to endless demands (sometimes implemented) for special bank "levies", the breaking up of the major banks (or at least their radical shrinking), competition enquiries and encouragement of a growing field of "challenger banks". Can it get any worse? Has it, in fact, gone too far?

What is it about the banks and their conduct problems that the public finds so distasteful? Is it their rigging of market benchmarks such as LIBOR? Their mis-selling of financial products to consumers, or to small businesses? Their manufacture and marketing of toxically complex derivatives? Their association with "tax dodging"? Their failure to cope with money laundering requirements in the battle against international crime? Their excessive remuneration and bonus culture? Their readiness to buy political influence? The crazy rogue traders? Insider dealers? Their harsh treatment of borrowers in difficulty? Are all these examples of poor behaviour to be regarded as equally contemptible? Or are some much worse than others? Are some really wicked whilst others more in the nature of technical errors, glitches or misunderstandings? Or is our condemnation a reflection of the way society in general has changed? Should we lump all failings together as examples of the waywardness of an industry that has hopelessly lost the plot? Or should we take a breather from the hue and cry, start looking more closely at the nature of the various issues, sorting the bad but forgivable from the inexcusable? Does it matter?

The financial sector legal reform theme of 2015 is a combination of "conduct" (and misconduct) coupled with a demand for more "personal responsibility" of individuals working in banks for that conduct (whether or not they were the direct perpetrators). Rolling off the ever-active legislative machine comes the new offence concerned with "reckless" management of a bank (leading to its insolvency) together with the new regulatory regime for "senior persons" in banks that will make them carry the can for failings of subordinates unless they can prove they could not reasonably have stopped the misconduct in question (thus reversing how the burden of proof normally falls). This is all in the name of making individuals accept personal responsibility and, implicitly at least, in response to the oft-heard question: why aren't more bankers in jail?

It's a popular, even populist, approach to a series of difficult problems. No one will lose votes for sticking it to the bankers! Margaret Hodge and her fellow politicians at the

Public Accounts Committee seemed to think of little else as they grilled senior representatives of HSBC at recent hearings, demanding to know if the accused (sorry, banker) accepted personal responsibility for all perceived (but ill-defined) wrongdoings at the bank's Swiss subsidiary. Accusations flew into the air and turned effortless somersaults between tax evasion, tax avoidance, "aggressive" tax avoidance, money-laundering and, heaven forbid, using bank accounts in Panama before coming to rest upon demands for resignation from a position at the BBC (held by a bank non-exec.) that had nothing to do with HSBC or with banking. The atmosphere was kangaroo court-like. The bankers were on trial before a group of politicians that had somehow morphed from being a Parliamentary Committee into a "Tribunal of the Proletariat", where the usual rules of criminal trials just did not apply. When a banker was asked "do you accept personal responsibility?" in such an environment one feared that an answer in the affirmative would be followed by the demand, "off with his head!". In any event, the demand for resignation was clearly primed and ready for firing, whatever the response. (It turned out, however, that this last demand (that Ms Rona Fairhead resign from her position at the BBC) was not supported by Ms Hodge's colleagues at the PAC and was toned down (later in the day) to a "personal opinion". (At the time of writing Ms Fairhead remains in post)).

But does this search for greater personal culpability risk undermining legal principles, the rule of law or simply notions of fairness as to what objectively might be considered to be an individual's responsibility? And what of the seemingly growing influence of the regulator as the de facto arbiter of fairness and morality, applying general 'principles' to highly complex (and inter-connected) factual circumstances?

The nature of responsibility in a corporate context

Whilst some of the political grandstanding may be regrettable, you can, as they say, "see where they're coming from". It grates to hear of banks agreeing to multi-billion dollar "settlements" with regulators but, in the same breath, saying there is "no admission of wrongdoing". Inactive or complacent shareholders, whose role is all too often stultified by the conventional investment management chain, seem to be prepared to let bank executives spend shareholders' funds to cover up individual incompetence, recklessness, crimes and misdemeanours. It is a source of frustration to many that the classic corporate responsibility structure --that applies to banks like other companies -- rarely results in "individual" or "personal" responsibility of the kind likely to result in an immediate resignation (or worse) unless the individual himself has been egregiously stupid or downright bad. The standard of care expected of company directors in general is, rightly, not particularly high and, putting the new regulatory regime to one side for a moment, an executive would not generally be thought to have "personal" responsibility for a colleague's gross misconduct (for example, complicity in tax evasion or money-laundering) unless he knew about it and did nothing to stop it. He might, however, (depending on his role) carry responsibility for a system of control that failed to pick up relevant warning signs and was never likely to do so...or if he had personally recommended the wrongdoer for employment by the bank and/or endorsed his character in some way. The level of responsibility that an executive has for a colleague's misconduct is very dependent on the particular facts. But it will rarely be at a level that equates to culpability as though the executive had committed the misconduct (which may amount to a criminal offence) himself. This is why the question, "do you accept personal responsibility?", can be so difficult to answer in a straightforward way. Annoying though it may be, the correct answer will frequently be: I am sorry this happened but I did all I reasonably could be expected to have done to prevent this kind of thing occurring. Add

to the mix (i) the fact that the individual may have previously signed a 'regulatory attestation' as to compliance, the existence of which may impact on the culpability question; (ii) the fact that acceptance of personal responsibility may well be followed swiftly by civil lawsuits, fuelled by contingency fee-driven lawyers; (iii) the tendency of those with criminal intent to have a talent for avoiding systems designed to control them; and (iv) the reality that we are often judging events of, say, seven or eight years ago by reference to the stricter standards that appear to prevail in 2015, and you can see that the "personal responsibility" question is fraught with much more difficulty than at first sight appears.

As to the latter point, the seemingly retrospective application of "moral" standards, an article by Jonathan Ames published in the Times (2nd April 2015: "City watchdog enters "terrible twos"") identified the problem as follows:

"The biggest worry is that the authority [the FCA] is retrospectively applying a post-global financial crisis morality. Buccaneering behaviour that several years ago was tolerated, even encouraged, is now viewed through an enlightened prism of propriety."

Even regulators are tempted to play to the gallery sometimes and the political pressure to be, and be seen to be, tough on bankers is almost impossible to ignore. And, as Ames goes on to observe, the combination of retrospectivity with the application of FCA "rules" that are in some cases vague in the extreme (Treat Customers Fairly springs to mind) raises rule of law concerns which become all the more pressing as the consequences of conduct failure, financial and reputational, have become so serious.

Culpability: ranking of conduct events

As virtually every bank news headline seems to involve a potential misconduct scandal and every consumer issue concerning banks is seen as a potential example of mis-selling, it is timely to consider the various categories of conduct problem that have come to light in recent times --they are not all the same-- and reflect on the different levels of responsibility and culpability that are involved. Although the LIBOR scandal brought ethics and morality to the centre of the stage, have we slipped into the habit of judging every bank conduct issue as an ethical failure and the ranks of senior bankers as a morality-free zone? Inevitably, a degree of subjective judgement is involved in an exercise of this kind but it is important to attempt some degree of analysis of the conduct problem that goes beyond the politically-driven rhetoric that threatens to dominate the debate. Banks, like all businesses fall foul of laws and regulations from time to time and, like all businesses, may find, despite their best efforts, that they have some dubious characters amongst their employees, some of whom can do great harm both to themselves and to others. No business is perfect. And not all misconduct is equally evil.

With this in mind, the following categories are proposed, in (suggested) order of bank culpability:

Case 1: "Clustered Criminality". This is where there is at least strong suspicion that a crime has been committed and although the culprits may not be immediately clear it seems likely that more than one person was involved. Classic examples: fraudulent manipulation of markets or benchmarks such as LIBOR, concerted complicity in tax evasion and breach of US sanctions regimes.

Case 2. "Corporate regulatory breach". This applies where there has not been any criminality but there is a clear breach of regulation. This will include corporate governance failings tied to a regulatory breach such as inadequate 'systems and controls', irrespective of whether or not there has been customer detriment or loss. Examples: PPI mis-selling or mis-handling of client money.

Case 3. "Imputed breach". This would be the case where a bank is not the "primary criminal" but it has committed a criminal offence or regulatory breach that is closely linked to, and arises by reason of, another's (actual or potential) criminal act. Examples: failure to comply with AML requirements and insufficient controls in relation to a customer's tax evasion (in relation to which new criminal offences have been proposed by various politicians in the wake of the HSBC Switzerland affair).

Case 4. "Corporate behavioural failure". This is similar to Case 2 . It does not, necessarily involve a clear regulatory breach but a pattern of behaviour (e.g. "poor practices") where the bank accepts that some redress to its customers is appropriate. Example: the FCA redress scheme for SME customers who have allegedly been mis-sold IRHP and other products. (This may turn out to be *sui generis*; the FCA itself refers to it as a "unique solution to a specific set of ..concerns").

Case 5. "Individual Criminality". This is where there is clear evidence that a crime has been committed by a bank employee and the culprit (usually acting alone) is identified. Classic examples: insider trading and the "rogue trader".

Case 6. "Corporate reputational event". This arises where the bank's reputation is severely damaged even though it may not have committed any crime or breach of regulation. Examples: the difficulties experienced by RBS in relation to GRG and its alleged harsh treatment of borrowers in default and the problems encountered by HSBC in relation to alleged complicity in its customers' alleged "aggressive tax avoidance". Egregious, unjustified bonus payments could also fall into this category.

Case 7. "Individual reputational event". This Case is for situations (not falling within any other Case) where a person employed by the bank or in some way associated with it behaves in a way that attracts criticism not just of that person but also of the bank itself. Example: the events reported in relation to the former Chairman of the Co-op Bank, Paul Flowers.

Justification of ranking

There will be differences of opinion about the "order of culpability" suggested above. Here is my justification:

1) Case 1 events tend to involve fairly widespread fraudulent and deceitful behaviour within a bank. Such events impact directly on the perception of an institution's 'culture'. The public's reaction to the LIBOR scandal, when it broke, showed that the mistrust of banks, already a problem following the crisis, was now to become an issue of much greater magnitude. This was evidenced by, for example, the formation of the Parliamentary Committee on Banking Standards, the very high fines and the resignations of Barclays' CEO and Chairman. In the case of US sanctions evasion, the punishment meted out to BNP Paribas for misconduct of this kind (an \$8.9bn dollar fine) was a near-death experience for the bank. The emergence of so many Case 1 events has, arguably,

made the growth of Case 4 and Case 6 events more likely due to the vulnerable position that has resulted for banks.

Case 2 events can be close to Case 1 in terms of the reprehensible nature of the conduct even though no crime may have been committed. PPI mis-selling showed a disdainful attitude to bank customers and the quantum of related conduct costs has reached eye-watering proportions. The episode has also set the tone for an ongoing epidemic of mis-selling allegations. However, in terms of culpability, this Case is not as bad as deliberate fraud or other crime. It may, for example, include IT system failures. These may give rise to great inconvenience and it is right that there should be a regulatory sanction but they fall a long way short of criminal behaviour.

Case 3 events are very serious, of course, involving, as they do, system failures on the part of banks to help with the effort to control organised crime, terrorism and tax evasion. The nature of the misconduct, however, usually involves poor management rather than deliberate wrongdoing. In recent times, the banks have, in effect, become involuntary adjuncts to the international law enforcement agencies. Their knowledge of our affairs, through their role in the financial system, provides access to information that such agencies are very keen to have.

Case 4 events, at the present time, consist essentially of mis-sales to entities (such as SMEs) who would not generally be entitled to make claims against banks purely on grounds of mis-selling alone. The creation by the regulator of the contractual framework for "fair and reasonable" redress (which was in response to a newspaper campaign) shows how times have moved on. In the present climate of opinion the banks' behaviour (in some cases at least) looks bad but it falls short of the level of culpability involved in Case 2. The Case also raises, in the context of the "sophisticated customer" issue, the somewhat unfashionable question of when the best of available evils is to insist that businessmen should not be allowed "extra protection" when they contract with each other (even if one party is much bigger and more powerful than the other.) They should perhaps get professional advice if they do not understand what they are being invited to sign. (How out of touch with the times is that?) Ten years ago, things may have been different.

Case 5 tends to involve a rogue employee "going off the rails". It is almost impossible for a bank to guarantee that this will never happen but banks are expected to have controls in place to make it unlikely and the behaviour of a lone miscreant may trigger a fine on the bank, whatever may happen to the individual in question.

Case 6 examples have started to grow as the media's interest in bank scandals, actual or potential, has grown. The bank may not have transgressed in the technical sense but, in an era when banks say they are anxious to restore public trust, a higher than usual standard of behaviour is now expected and any conduct that appears to take advantage of a customer's weakness is likely to make lurid headlines, even though the moral judgement may be somewhat hindsight-based. A Case 6 event may evolve into a Case 4 event. Case 6, perhaps more than any other, shows the need for consensus building on what standards should now apply in sensitive situations. The need for "soft-regulation" is most obvious in this context. More industry -wide consensus is required on "what is right and what is wrong" in the grey areas where society's perception of business morality seems to shift more swiftly with each passing year and conventional regulation can no longer achieve this.

Case 7, like Case 5, is concerned with individual behaviour, in this case falling short of a crime (or, at least, a crime related to the bank's activities). The political climate at present is such that if a senior banker was caught shop-lifting it would be turned into an anti-bank story.

“Scoring” and other issues raised

If one were to turn the above Cases into a scoring methodology, one would have to take account of "volume" in some way. A bank that has a £10bn PPI problem should register more on the culpability scale than one that has only transgressed the regulatory requirements in isolated occasions with minimal ‘Conduct Cost’ consequences. Similarly, there is a case for more sympathetic treatment for a bank that genuinely misconstrued the more technical aspects of client money rules (which even the regulator failed to fully grasp) than one which deliberately flouted them. There is room for refinement and sub-categorisation within each Case (with Case 2 being an obvious candidate for subdivision). Given that it would seem impossible to eradicate failings that fall within, for example, Case 2, it is surely important to develop some degree of moderation as to how we respond to conduct failure rather than treat every incident as a cause for a major fine, resignations at senior level and a Parliamentary enquiry.

The different Cases also show the many different ways that a bank may be "caught out" by a multitude of overlapping and inconsistent requirements that operate in different ways, with different views of business morality, in different jurisdictions. (It is hard to imagine a bank in another part of the EU undergoing the equivalent of a PAC kangaroo court hearing for example). It is not surprising that many commentators are beginning to question whether certain banks are too big and/or too complex to manage. Scaling down and "de-risking" are now common bank responses to the problems that these phenomena present. The old business models are being revised. There is a danger, however, that we allow, even encourage, a rushed move to new business models, as a panic response to a hostile regulatory environment, without a measured consideration of the advantages and disadvantages, for society as a whole as well as banks and their shareholders, of the various business models available. It is of fundamental importance that true causes (and their consequences) are understood in their proper context and that this process of re-aligning legal risk in financial markets to disincentivise misconduct more effectively, takes account of this.

If some degree of consensus could be reached on the Cases, and an accompanying scoring methodology, they could prove to be useful (in conjunction with our Conduct Costs Project data) in comparing how, say, the UK compares with the US or the EU as regards not just the financial cost of poor conduct but also the incidence of the more serious kinds of poor conduct. (It will be appreciated that some of the Cases may not necessarily result in a conduct cost for the bank). A bank-by-bank comparison would also be a useful tool not only for regulators and customers but also for the banks themselves. One suspects, for example, (although the detailed data are not yet available) that (a) Case 2 would be a UK and US problem much more than an EU problem (b) poorly managed banks would tend to feature prominently in Cases 1, 2 and 3 (c) Case 5 is geographically quite widespread and may hit banks that do not have major problems with other Cases and (d) Case 6 is probably confined to the UK. A bank that scores heavily in Case 1 or Case 2 would need to show how it is addressing the problem and improve its performance as a matter of considerable urgency. That is not to say that there is room for



complacency as regards the other Cases, of course, but the reputational, as well as financial damage caused by the first two Cases could now bring a bank down quite quickly if the problems are not addressed.

Potential for further analysis

If the research shows such differences, what should we make of them? Are banks better behaved in continental Europe? Do differences in the general law of contract there (such as duties of good faith) make them behave more responsibly? Or are they just better at covering their tracks? (Perhaps they have more obliging regulators?) Is anyone selling anything like PPI anywhere else apart from the UK? Do SMEs have swap problems anywhere else apart from the UK? Has any other regulator (outside the UK) set up anything like the SME/IRHP redress scheme? Is the rogue trader problem now under control? Is anyone else changing the law relating to "personal responsibility" of bankers in a similar manner to the UK? How many criminal convictions have been handed down, country-by-country and bank-by bank? Which Cases gave rise to (a) most criminal convictions or other disciplinary action against individuals? (b) most resignations at senior level and (c) most successful compensation claims? And are there correlations between Cases and lines of business? It is a big field of enquiry and if we could pursue it seriously it would inform our thinking. It might even make us react in a more measured way when the next scandal comes along. The eighth deadly sin would be to fail to recognise that there is more than one side to the conduct story.

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