Senior Managers Regime (SMR)

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Abstract

Due to a perception of endemic behavioural and cultural problems within the banking industry and repeated failings of legislation to address these failings, a new Senior Managers Regime (SMR)[1] is being introduced.

New binding SMR rules are due to be released in early 2015.

The new rules will specifically address the perceived problem of individual accountability where previously an individual had greater scope to shirk responsibility. The new list of managers caught under this new regime will be narrower than the one caught under the previous "Approved Persons Regime" (APR) which is being phased out.[2] The lines of responsibility will now be much clearer, by removing ambiguity and confusion. There will also be much harsher penalties for non-compliance.

Both the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) (the regulators) believe that holding individuals to account is a very important component to effective regulation.

Background and what to expect?

The new SMR binding rules will be the result of a lengthy adoption process and will be released in conjunction with a new '**Certification Regime'** and **'Conduct Rules**'. This forms part of a broader implementation scope which began in October 2013 when **"The Parliamentary Commission on Banking Standards (PCBS)"** published its report **"Changing Banking for Good"** setting out 100+ recommendations.

These recommendations resulted in:

a) Amendments to the "Financial Services (Banking Reform) Act 2013 (the Act)",

b) Amendments to the "Financial Services and Market Act 2000 (FSMA)" and,

c) A Joint FCA and PRA consultation paper released in July 2014, under the title "Strengthening accountability in banking: a new regulatory framework for individuals".

Justin Welby, The Archbishop Of Canterbury, who sits on the board of Think tank 'New City Agenda', advising the UK government on new bank policy.

"...the fines imposed on banks [recently] for FOREX rigging showed the length of the journey of cultural change that still needs to be travelled"

Dec 2014

Tracey McDermott, Tracey McDemott is an Executive Board member and Director of Supervision and Authorisations at the Financial Conduct Authority (FCA).

"Overhauling the culture of the City requires a generational shift in attitudes akin to that seen for drink-driving in recent years..."

Dec 2014

[1] *Consultation Paper | ***FCA CP14/13/PRA CP14/14 - Strengthening accountability in banking: a new regulatory framework for individuals |*

[2] *FCA, 8 July 2013, "Government to scrap 'failed' approved persons regime (APR) |*

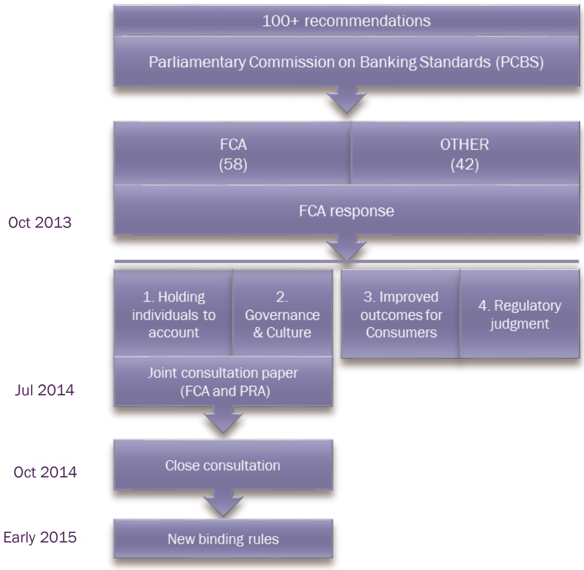

Table: SMR Adoption Timeline

The **Senior Managers regime** has in **essence** been designed to hold the most senior individuals to account at top banks and financial institutions, whose behaviour and decisions have the potential to bring a bank or financial institution to failure, or cause serious harm to customers.

The new **SMR rules** will allocate clearly defined responsibilities to individuals with specific requirements to regularly vet the fitness and propriety of all individuals.

It will greatly enhance the regulators (FCA and PRA) ability to hold individuals to account.

These rules are significant and shouldn't be taken lightly.

As previously mentioned, the focus on accountability will be much narrower than the current Approved Persons Regime (APR)[3]. The new SMR will replace the "Significant Influence Function (SIF)" element of the "Approved Persons Regime (APER)" for deposit-takers and PRA designated-investment firms with a Senior Management Function.

The new '**Certification Regime**' will require regular assessment of fitness and proprietary of certain employees who could pose a risk of significant harm to the firm or any of its customers and work in conjunction with the '**Senior Managers Regime'** and new '**Conduct Rules'.**

Scope: Which firms does this apply to?

- "Relevant firms" – UK banks, Building societies, Credit Unions and PRA dedicated investments firms
- All foreign banks that operate in the UK*(a)
- Insurers and re-insurers *(b)

Note (a)[4]: In his annual Mansion House speech of 12 June 2014, the Chancellor of the Exchequer, George Osborne, stated his intention to extend the definition of 'relevant authorised person' in section 71A of FSMA to include 'all banks that operate in this country, including the branches of foreign banks'. The Treasury has since agreed this approach with the Bank of England and the FCA and is currently consulting more widely with affected firms, customers and relevant representative bodies.

Note (b)[5]: falls under the scope of SIMR – a new Senior Insurance Mangers Regime (PRA CP26/14)

UK Chancellor, George Osborne

"Cultural reform in the banking sector marks the next step in the Government's plan to move the sector from rescue to recovery and ensure that UK banks demonstrate the highest standards, and are able to support business and drive economic growth"

{Dec 2014}

Scope: Who is a Senior Manager?

- All Board members, including non-executive directors.
- Executive committee members (or equivalent) "the layer below the board…" [1.19 FCA CP14/13/PRA CP14/14].
- Heads of key control functions and major divisions.

[3] Under the Financial Services and Markets Act 2000, the FCA may approve an individual as an Approved Person |
[4] HM Treasury | Regulating individual conduct in banking: UK branches of foreign banks 17 Nov 2014 |
[5] Bank of England | Prudential Regulation Authority | Publications |Senior insurance managers regime: a new regulatory framework for individuals – CP26/14 |

- Individuals employed outside the firm who exercise significant influence.

- Certain functions currently classed as 'required functions' under the Approved Persons Regime (APER) e.g. Money Laundering and Compliance functions.

All Senior Managers will need to be pre-approved by the FCA or PRA in line with "fit and proper" guidelines.

Senior Manager	Short name	Regulator
Chief Executive	SMF1	PRA
Chief of Finance	SMF2	PRA
Executive Director	SMF3	FCA
Chief of Risk	SMF4	PRA
Head of Internal Audit	SMF5	PRA
Head of Key Business Area	SMF6	PRA
Group Entity - Senior Manager	SMF7	PRA
Credit Union SMF (small only)	SMF8	PRA
Chairman	SMF9	PRA
Chair of Risk Committee	SMF10	PRA
Chair of Audit Committee	SMF11	PRA
Chair of Remuneration Committee	SMF12	PRA
Chair of Nomination Committee	SMF13	FCA
Senior Independent Director	SMF14	PRA
Non Executive Director	SMF15	FCA
Compliance Oversight	SMF16	FCA
Money Laudering Reporting	SMF17	FCA
Significant Responsibility SMF	SMF18	FCA

Legend
SMF = Senior Management Function
PRA = Prudential Regulatory Authority
FCA = Financial Conduct Authority

Table: Senior Management Functions (SMF) caught under the new regime.

New requirements for Senior Managers

Below are some of the new requirements placed on Senior Managers. A breach of any of these would constitute a contravention.

- **Presumption of responsibility** ('presumed responsible and potentially guilty') – a Senior Manager is now solely responsible and accountable for his/her area. A Senior Manager will be presumed guilty of a contravention(s), unless he/she can satisfy regulators that they have taken 'reasonable steps' to prevent or stop that contravention(s).

- **Time limits** – the regulator can now set time limits on the approval of Senior Managers and also can impose conditions.

- **Pre-approval and re-approval** – Senior Managers will have to be pre-approved by the regulator and reapproved at set intervals.

- **Responsibility Maps** – will need to be prepared by your organisation for each area of responsibility. It should be a single document that describes the firm's management and governance arrangements.

- **Statement of Responsibilities** – will need to be prepared by your organisation and it will need to set out the area of the firm each Senior Manager will be responsible for.

Harsher penalties

- Up to 7 years in prison.
- Unlimited fines.
- Delay bonuses by up to 7 years
- 100% claw back on pay and pensions up to 10 years

What are 'reasonable steps'?

Section 2.5 of Consultation Paper [FCA CP14/13/PRA CP14/14] states: "that If a firm contravenes a relevant requirement, the Senior Manager responsible for the area where the contravention occurred, could be held accountable, if they are unable to satisfy the regulators that they have taken **'reasonable steps'** to prevent or stop the contravention (the 'Presumption of Responsibility')."

This implies that a Senior Manager is wholly responsible for his/her area and presumed potentially guilty until they can prove their innocence of a contravention(s) by showing that they have taken 'reasonable steps' to avoid the contravention.

This is a new burden of proof on Senior Management.

There are guidelines in the Conduct rules of the Consultation Paper [6] as to what constitutes 'reasonable steps' and what 'reasonable steps' should be taken by a Senior Manager at all

[6] *(7.2 Draft conduct rules) of the joint FCA and PRA Consultation paper (FCA CP14/13, FRA CP14/14) is a definition for Conduct rules (Draft) and what is expected of a Senior Manager.*

times. It is expected that there will be more details when the binding rules are released.

Senior Manager Conduct Rules – 'reasonable steps'

You must take 'reasonable steps' to ensure that the business of the firm for which you are responsible …

SM 1 …is controlled effectively.

SM 2 …complies with the relevant requirements and standards of the new regulatory system.

SM 3 You must take 'reasonable steps' to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee this effectively.

SM 4 You must take 'reasonable steps' to ensure that any breach of the firm's regulatory obligations of which you are aware is being appropriately addressed.

SM 5 You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

In addition to this you must[7]:

1. Act with integrity,
2. Pay regard to customers and treat them fairly,
3. Observe proper standards of market conduct,
4. Must act with due skill, care and diligence, and
5. Be open and co-operative with the FCA, PRA and other regulators.

In practice, the application of these Conduct rules will be used in conjunction with common law principles of a 'reasonable person' in determining a contravention and whether you have taken the necessary 'reasonable steps'.

- Comply with the draft SMR requirements in full. This means adhering to new governance arrangements and preparing yourself for new binding rules in Q1 2015.
- Be seen as proactive and not reactive when it comes to dealing with accountability and conflict issues.
- Be seen as acting honestly and with integrity; and in line with the principles guiding the new binding rules. This includes acting with the 'intent' to be honest.
- Take steps to avoid jeopardising customer's interests.
- Take steps to avoid causing potential bank or organisation harm or failure.

Costs of compliance

The table below estimates implementation and ongoing compliance costs of SMR for banks, building societies and credit unions. It was commissioned by the FCA.

SMR Compliance costs - Estimated one-off cost (£ millions)[8]

	Large	Small
Banks	170	67
Building Soc.	17	2
Credit Unions		5

SMR Compliance costs - Estimated ongoing cost (£ millions)

Banks	10	13
Building Soc.	3	0.3
Credit Unions		1.2

Attestation

A major frustration of the FCA's predecessor (the FSA) was that whilst a firm might be fined for misconduct their senior managers

[7] *First tier | Expectations of Relevant Persons FCA CP14/13, FRA CP14/14 |*

[8] *The FCA commissioned Europe Economics (EE), a specialist economics consultancy, to assist in assessing the likely impacts related to conduct of the proposed new accountability regime (the "EE report") |*

were rarely fined or held accountable. An attestation is another tool the regulator is now more willing to use to overcome this problem.

Making Senior Managers attest to their specific responsibility is becoming increasingly common and a cause for concern.

Attestations are direct personal accountabilities on Senior Management by the regulator (FCA & PRA). It informs the regulator that you are complying with your regulatory obligations. It could take the form of a letter.

Or attestations can be used to obtain a personal commitment that a specific action has been or will be taken. It provides the regulator with an assurance that change in culture and accountability is improving without actually getting involved.

The literal meaning of "attest" is to declare that something is "the case" or is "in existence".

Attestations should be specific, achievable and have realistic time lines. Again, 'reasonable steps' need to be taken to ensure that the firm appropriately monitors risk and escalates when required.

An industry led initiative

Set out in the *Lambert Review proposals*[9] which recommends creating a *Banking Standards Review Council* to act as an independent champion of behaviour and competence in banking.

"Through the setting and monitoring of voluntary standards of good practice, the industry may seek to attain higher standards than the minimum requirements imposed by the regulators."[10]

Case Study: **HSBC Board members quit in advance of new stricter conduct rules, Oct 2014.**[11]

Alan Thomson, who sat on the audit and risk committees of HSBC Bank plc. resigned in October 2014 and John Trueman the UK operations' deputy chairman, announced his intention to resign soon after. Both gentlemen cited stricter incoming conduct rules and the regulators desire to make senior managers more accountable as major reasons for their departures.

Thomson and Trueman are said to have reconsidered their positions after they were briefed by HSBC compliance officers about the joint FCA and PRA proposals announced in July 2014.

Trueman had been a director of HSBC Bank for 10 years. Thomson was appointed to HSBC's UK board only a year earlier. Renato Fassbinder also quit after a year as chairman of the audit committee.

The biggest fear amongst senior managers regularly cited is the government's decision to reverse the burden of proof for culpability of senior individuals when there are regulatory failures – as well as the sheer complexity of the set-up.

The new rules include giving "senior managers" a clear definition of responsibility and making them accountable for any misconduct in that area, as well as introducing a new criminal offence of reckless misconduct that causes a financial institution to fail. There is no equivalent offence elsewhere in the world.

There is little equivalent legislation in the US, although the **Volcker rule** requires chief executives to ***attest*** annually that their banks are in compliance with the proprietary trading ban, potentially leaving them personally liable if there are any breaches.

The 'Banking Reform Act'[12] specifies that senior management functions are those individuals who are "taking decisions, or participating in the taking of decisions, about how one or more aspects of [the firm's] affairs should be carried on. As a conduct regulator our view is that this covers both executive and non-executive directors. Our proposals, which are subject to consultation, reflect this.[13]"


Andrew Tyrie, MP

Responding to the HSBC departures, Andrew Tyrie MP, chairman of the Treasury Committee and a driving force behind the new regime, said: "The crisis showed that there must be much greater individual responsibility in banking. A buck that does not stop with an individual often stops nowhere[14]."

[9] *Banking Standards Review, Richard Lambert, 19 May 2014 |*
[10] *Page 10 1.17 FCA CP14/13/PRA CP14/14 – Strengthening accountability in banking: a new regulatory framework for individuals |*
[11] *HSBC directors to quit over threat to jail bosses for banking crises, The Guardian Oct 7 2014. |*
[12] *Financial Services (Banking Reform) Act 2013 |*
[13] *The Financial Times 17 Oct 2014 | Two HSBC directors quit in protest over new conduct rules |*
[14] *Financial Times 17 Oct 2014 | | Two HSBC directors quit in protest over new conduct rules |*

Next Steps and how we can help?

In anticipation of the new binding rules, firms should be doing (at a minimum) the following:

- Identifying Senior Managers caught within the Regime.
- Preparing responsibility maps with clear lines and linkage, including delegation.
- Preparing Statements of Responsibility for each Senior Manager, including 'reasonable steps'
- Being seen as proactive and transparent in SMR adoption.
- Identifying gaps in SMR organisational structure.
- Informing and advising Senior Managers about the seriousness of the new regime and their specific obligations.
- Preparing a group wide impact assessment.
- Planning a SMR control framework which incorporates annual reviews of fitness and proprietary.
- Building a central data repository.
- Obtaining FCA/PRA pre-approval for new Senior Managers.

Avantage Reply, can help firms prepare for these incoming deliverables and we also work closely with regulators to ensure cost effective compliance.

Avantage Reply, will publish a more detailed note upon release of the new binding rules in Q1 2015.

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