Culture and conduct through the lens of the UK's Senior Managers and Certification Regime

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Speaking on 20 September 2017, Jonathan Davidson—Director of Supervision for Retail and Authorisations at the Financial Conduct Authority ("**FCA**")—addressed the issue of culture and conduct in financial services, in light of the introduction and recent proposed extension of the Senior Managers and Certification Regime ("**SMCR**").

The 'accountability regime'

The SMCR came into effect for the UK's banking industry (i.e. approximately 900 banks, building societies and credit unions) on 7 March 2016. Designed to hold senior managers accountable for conduct failings in their designated areas of responsibility, the SMCR replaced the Approved Persons Regime ("**APR**") for banks and was the FCA's response to the 2013 Parliamentary Commission on Banking Standards report, '*Changing banking for good*' (the "**Report**"), in which the APR was derided as offering an, "*illusory impression of regulatory control over individuals, while meaningful responsibilities were not in practice attributed to anyone.*" On 26 July 2017, the FCA published a consultation paper setting out its proposals to extend the SMCR to, and replace the APR for, the remainder of the 47,000 or so other FCA regulated firms.

Why is culture so important?

The 2007 financial crisis, the LIBOR rate-rigging scandal and other major conduct failures prompted the appointment of the Parliamentary Commission on Banking Standards to conduct its inquiry into professional standards and culture within the UK banking sector. In his speech, Davidson elided two of the Report's key themes—holding individuals to account and governance and culture—and in doing so was explicit that the imposition of significant fines and other forms of redress put in place to discourage such misconduct is *not* enough: the financial services industry cannot merely be coerced into behaving. He made clear his view that, "*an ethical culture can be more powerful than one based solely on financial incentives*."

There may also be a more pragmatic reason for the FCA's renewed focus on the culture of firms in the financial services sector, shortly after issuing its consultation on the proposed extension of the

SMCR to cover a total of around 56,000 regulated firms. As Davidson acknowledged, "*We* [the FCA] *cannot continuously and closely supervise outcomes in every one of these firms. Our ambition is to be forward looking and pre-emptive by addressing root causes*." In its desire to prompt the regulated private sector to identify and address the causes of regulatory misconduct itself and for the regulated and the regulator to work closely together, the FCA is aligned with the Solicitor General who, albeit addressing criminal rather than regulatory misconduct, recently emphasised the key role of the private sector in preventing and controlling economic crime.

The four 'levers'

Davidson explained that the FCA will found its assessment of how a firm's management create and administer a firm's 'culture' on management's use of four so-called "*levers*":

1. *"A clearly communicated sense of purpose and approach*"—which should encompass the 'what', 'how' and 'why' of a firm's purpose and approach.
2. *Tone from the top*"—what staff see and hear from senior management.
3. *Formal governance processes and structures*"—systems and controls designed to identify, mitigate and monitor conduct risks.
4. *"People related practices*"—which should encompass a firm's remuneration, promotion and recognition criteria.

Beyond a 'fear-based' culture

Throughout his speech, Davidson sought to provide assurance that the FCA will not be holding senior managers automatically liable for any breach of the conduct rules occurring in their area of responsibility. This is understandable given the widespread concern that a regime based solely on enforcement could prove too burdensome and ultimately discourage people from taking-up senior management roles.

Davidson drew examples from behavioural economics to bolster the idea that fear and money are inadequate motivators. Being able to put a price on breaking the rules, he argues, signals a form of absolution, whereas being viewed negatively by one's peers is a far more powerful compliance motivator. Rather optimistically perhaps, Davidson hopes that firms will be able to leverage what he regards as the innate desire of those working in the financial services industry to be thought of as, "*good people*".

A balancing act

The FCA's desire to overhaul the culture of the financial services industry and make compliance personal, is well-intentioned and few would argue with Davidson's conclusory preposition that "*having the right culture is just good business*". It ought not overlook the primary purpose of introducing the SMCR, however, which was to help the regulator penetrate the 'accountability firewall' of collective responsibility in firms and bring about a more effective regime of sanction and enforcement against senior individuals.

The pursuit of meaningful cultural reform and an active enforcement regime are natural bedfellows in a well-functioning regulatory system. Indeed, the FCA will be alive to the difficulties of focusing solely on the amorphous concept of cultural reform, having been heavily criticised for its decision in December 2015 to drop its commitment to undertake a thematic review into whether cultural change in banking was driving the right behaviours, citing that the idiosyncratic nature of each bank rendered issuing generalised good and bad practice guidance meaningless.

Authors

Lloyd Firth

COUNSEL

lloyd.firth@wilmerhale.com

+44 (0)20 7872 1014