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CRIMINALISING BANK MANAGERS

Julia Black and David Kershaw
Professors of Law,
London School of Economics
and Political Science

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Senior managers and directors of banks are soon to face a new criminal offence, that of 'reckless misconduct in the management of a bank'. The Chancellor, George Osborne, has recently announced that the government will adopt the Parliamentary Commission on Banking Standards' recommendation of criminalising reckless behaviour of senior bankers for management failures which lead, for example, to taxpayer bail-outs or significant customer harm[1].

Introducing criminal liability would give a strong signal of society's disapproval of the conduct that led us into the financial crisis. It would also, in the opinion of many of the public, address the view that the scope of criminal law is in some sense unjust because it criminalises smaller scale misconduct but does not hold powerful businessmen responsible for the economic destruction wrought by the financial crisis. It is also hoped that it would prompt directors and senior managers radically to improve their own standards of behaviour, and those within the organisations that they manage.

But whilst it would provide a clear signal of disapprobation, would criminal liability prove to be the silver bullet that policy makers may be hoping for? Two key questions need to be addressed: what degree of failings should give rise to criminal liability, and if introduced, what deterrence effect is it likely to have?

Prior to the Commission's report, the Treasury had issued a consultation paper considering three potential standards of liability: strict liability, negligence (including incompetence), and recklessness. A strict liability offence would have been a radical change indeed: directors or senior managers of failed banks would automatically be subject to criminal sanctions. If a strict liability standard were adopted the deterrent effect is likely to be significant, but a strict liability standard that gives rise to significant criminal fines or incarceration when the individual has not been at fault is likely to be seen as draconian by the courts, and so the deterrent effects may in fact be negated by the imposition of low fines, as has happened in other areas of regulation where strict liability offences are common. This weakens the deterrent effect and diminishes the stigma attached to the criminal offence.

A negligence standard would also have presented difficulties. While a negligence standard for corporate individual crimes is not unheard of it is problematic for a number of reasons. Not least, as with a strict liability standard, it could deter people from taking up senior positions within financial institutions. As bank failings are judged with hindsight, many managers would fear that their competent and reasonable risk taking activity may be judged more harshly after the event. This could result in excessive risk aversion by managers and directors, or their refusal to serve. Indeed, the more risk-averse managers and directors are more likely to refuse to serve which means that such a standard could paradoxically lead to only those who are risk-takers self-selecting to become members of bank boards or senior management, and thus a have negative effect on bank conduct from society's perspective. Furthermore, as the standard of conduct required is assessed by reference to one's peers, if everyone else is behaving in the same way, the court is may not judge it to be negligent, no matter what the others might think.

In our evidence to the Commission, we argued that the critical argument against either standard is that criminal offences are typically associated with very serious failings, and individuals should not be subject to criminal liability unless their wrongdoing is knowing or reckless. Liability for recklessness is not unknown in corporate law, albeit on a civil standard. In the US, for example, in Delaware corporate law, the civil care standard for directors is: "reckless indifference to or deliberate disregard to the whole body of shareholders". We therefore argued that *if* any criminal offence were to be introduced, the standard should be one of reckless misconduct. The Commission has agreed.

Introducing criminal liability for reckless misconduct has had the short term effects we predicted. It has grabbed the headlines, given legislators something to do, and sends a clear signal that society has, quite frankly, had enough of the way that those managing financial institutions have behaved. It will provide a lucrative revenue stream for lawyers and consultants advising them. It might even have a short term effect on directors' or manager's behaviour.

But will it have a lasting deterrent effect? The Commission was under no illusions about the difficulties in prosecuting

* j.black@lse.ac.uk; r.d.kershaw@lse.ac.uk

1 Parliamentary Commission for Banking Standards, vol 2, para 1182.

2 HM Treasury, Sanctions for the Directors of Failed Banks, July 2012

such an offence, but argued that it would at least cause senior managers to 'pause for thought' before acting. We would hope that it does have this effect, but the risk is that if prosecutions are never brought, or perhaps worse, if brought but fail, then the length of that pause is likely to diminish or perhaps disappear entirely.

For any sanction to be effective, whether it is criminal, civil or regulatory, or indeed imposed by a parent on a recalcitrant child, it has to meet four conditions: the person infringing the standard has to be detected; the enforcer has to decide that it is worth spending valuable time and other resources in bringing an action; the action has to be successful; and the sanction has to be meaningful.

Each condition can be difficult to satisfy. Monitoring and supervision requires significant resources, yet there are inevitable asymmetries of knowledge, expertise and resources between regulators and regulated which put regulators at a structural disadvantage.

As to the second condition, in the context of limited resources, decisions on whether or not to bring actions require trade-offs to be made. Like any regulator the FCA and PRA have to make real choices as to how to allocate limited enforcement resources. The costs of enforcement actions are very high, particularly if the firm is willing to defend the individual (compare the fates, and costs, of the cases against Mr Pottage and Mr Cummings), and legal costs can far exceed the value of the fine. For a regulator to compete effectively with such deep pockets and to increase the probability of successful suit would require very significant increase in resources. But, as the Madoff scandal highlights, even comparatively rich US regulators are subject to clear resource constraints that put them a significant disadvantage in identifying and understanding financial crime.

Even if an action is brought, the challenge with any criminal standard, especially one of recklessness, is that it is very difficult to prove, especially with a criminal burden of proof. This is particularly the case where risk management systems are in place and where the risk strategy adopted by the bank is a rational one for the bank and its shareholders (if not for society). Furthermore, pinning liability on individuals in large organisations where decision making processes often involve multiple individuals, and where responsibilities are often only broadly defined can be a difficult (though not impossible) task. We have seen how difficult it is to bring actions under the lower standards both of conduct and of proof imposed by the regulatory regime under APER; raising those standards will only exacerbate the problem. Furthermore, even where the activity in question is clearly unlawful—such as with LIBOR rigging—managers can communicate preferences which result in misconduct without referring to or directing subordinate employees to engage in such misconduct. In such instances the chances that managers will be found to fall foul of a recklessness standard are very low. The Commission's proposals to reform the Approved Persons scheme have significant merit in extending the scope of personal liabilities throughout financial institutions and in requiring greater specification of the the responsibilities of senior managers, but the potential for avoidance always remains.

Finally the sanction has to be meaningful. The FCA and PRA have a wide range of sanctions which they can impose on both firms and individuals. However, the effect of sanctions can be blunted through the use of procedural negotiating tools such as plea bargaining, and in the context of criminal actions, sanctions may also be muted by the view, possibly, that financial crime is not as morally culpable as other types of crime. In addition, and perhaps more relevant in the regulatory context, there has been a longstanding fear—which is being partially corrected—that aggressive regulatory action will damage the attractiveness of the UK's financial industry. This fear, together with a political climate which was perceived as unsupportive of tough regulation of international financial institutions or their senior managers, has had a significant effect on regulators' behaviour in the past. Once public disapprobation wanes, and if the economy ever picks up, it is likely that the political climate will revert back from its current emphasis on 'banker bashing' to one which is once again 'light touch'.

But even if a criminal sanction is not introduced, regulators are clearly going to be paying much more attention to the responsibilities of individuals than they have in the past. Directors and senior managers would therefore be well advised to take far greater note of their personal regulatory obligations, and industry bodies such as the British Bankers Association or Institute of Directors could have a role in producing clear guidance to them as to just what their responsibilities are. But changing the culture of banks cannot come from the outside; it has to come from inside, and from the top. Sanctions play a role, but ultimately it is the structural incentives in place within financial institutions which shape behaviour; whilst they remained focused on sales and profits to the expense of all else, then we are no further forward, no matter what the law requires.

The Law and Financial Markets Project is based in the LSE's Law Department. The project provides a framework for a research group of LSE faculty and associated participants from outside academia to explore the interactions of law, regulation, financial markets and financial institutions, principally within the EU and the UK.

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Law and Financial Markets Project

PROJECT MEMBERS

Prof Julia Black, Project Director
Dr Jo Braithwaite
Prof Michael Bridge
Dr Carsten Gerner-Beuerle
Prof David Kershaw
Dr Eva Micheler
Prof Niamh Moloney
Dr Philipp Paech
Dr Edmund Schuster

POSTDOCTORAL RESEARCHER

Dr Guiliano Castellano

VISITING PROFESSORS

Jonathan Fisher QC
Prof Christos Hadjiemmanuil
Roger McCormick

Julia Black is a Professor of Law at the London School of Economics and a research associate of the Centre for Analysis of Risk and Regulation (CARR) and a co-investigator of the ESRC Centre for Systemic Risk.

David Kershaw is a Professor of Law at the London School of Economics and a Senior Researcher of LSE's Financial Markets Group (FMG) and a co-organiser of the FMG's Corporate Governance at LSE.

For further updates and contact details visit the Project's website:
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Department of Law
The London School of Economics
and Political Science
Houghton Street
London WC2A 2AE