Was the Co-op Bank too fragile to punish?

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Financial Services analysis: As the dust settles on the final notices issued by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) in respect of regulatory breaches committed by the Co-op Bank, how can regulated firms avoid the Co-op's mistakes? Charlotte Eborall, a barrister at 3 Verulam Buildings in London, comments on the outcome and the lessons that can be learned.

Original news

Co-op bank misled stakeholders, FCA and PRA find, LNB News 11/08/2015 103

On 1 August 2009, the Britannia Building Society merged with the Co-op, (both operating under their original names after the merger). Under the merger, the Co-op took on accounting liabilities, 'Leek Notes', in addition to its own liabilities--for example, provisioning in relation to payment protection insurance (PPI) claims. In April 2013, the Co-op withdrew from the potential purchase of 630 odd TSB branches from Lloyds Banking Group (referred to as Project Verde), because in January 2013, the Financial Services Authority (FSA) had informed the Co-op of its revised capital requirements, which it was having difficulty in meeting. Indeed, in June 2013, the Co-op was required to announce that it had a £1.5bn capital shortfall such that it was unable to meet its capital requirements. This announcement led to a joint investigation by the FCA and PRA into the Co-op's capital failings.

The PRA determined that the Co-op had failed to maintain adequate systems and controls under principle 3 of the PRA's Principles for Businesses in that the Co-op's 'three lines of defence' had failed to identify this significant capital shortfall. The FCA held that the Co-op had breached the Listing Rule 1.3.3 R (misleading information not to be published) by failing to inform investors and the market in its 2012 accounts of this deficit. Both regulators considered that there had been a principle 11 breach in that the Co-op had not cooperated openly with its regulators by failing to notify the regulators of intended changes to two senior management positions.

The final notices impose public censures, issued under the Financial Services and Markets Act 2000, ss 91 and 205 (FSMA 2000). However, the Co-op has avoided having to pay a financial penalty. Although the FCA does not give a figure, the PRA states that it would have imposed a penalty in the sum of £121.86m.

Although both FCA and PRA have issued their final notices, investigations remain ongoing into the roles of senior individuals at the Co-op, and the role of their auditors.

What is the background to the FCA censure?

For the period 21 March 2013-17 June 2013 the Co-op breached the FCA's Listing Rule 1.3.3R (misleading information not to be published). This was as a result of the statements made on its capital position in its financial statements for the year ending 31 December 2012. In addition, from 25 April 2012-9 May 2013 the Co-op also breached principle 11 by failing to notify the FCA of intended changes to two senior positions (and the reason for those changes).

The UK listing regime relies on disclosure and transparency to allow investors to make fully informed decisions. It is of fundamental importance to achieving the FCA's objective of making the relevant markets work well that market disclosures by listed companies are not only timely, but also accurate. This ensures they can be relied on by investors in making investment decisions to hold, buy or sell an investment. By making statements about its capital position that were misleading in its annual report, the Co-op fell significantly below the standards expected of listed companies in the UK.

On 21 March 2013, the Co-op published its 2012 financial statements for the year ending 31 December 2012. The 2012 financial statements showed a loss of £673.7m. This was a significant change to that expected by the Co-op only a few months previously. A major contributory factor to this was impairment losses of £474.1m. These resulted in large part from work required after the year end to comply with the standards for provisioning set out in a 20 December 2012 letter from the FCA to the all regulated firms. In addition, there was a further provision for PPI claims of £149.7m and a partial write-off of the value of a new bank IT system in the amount of £150m.

The 2012 financial statements contained the following statements in relation to the Co-op's capital position:

- adequate capitalisation can be maintained at all times even under the most severe stress scenarios, including the revised FSA 'anchor stress scenario', and
- a capital buffer above individual capital guidance (ICG) is being maintained, to provide the ability to absorb capital shocks and ensure sufficient surplus capital is available at all times to cover the Bank's regulatory minimum requirements

Statements made about capital are crucial to readers of banks' financial statements. They are a key guide to the health and future stability of a firm. These statements about capital in the 2012 financial statements were false and misleading.

In fact, since 15 January 2013, when the FSA issued the Co-op with revised capital requirements, the Co-op did not have sufficient capital to meet its revised capital planning buffer. This was the capital buffer set down by the FSA 'to provide the ability to absorb capital shocks and ensure sufficient surplus capital is available at all times to cover the Bank's regulatory minimum requirements'. From this time there were frequent discussions between the Co-op and the FSA (and from 1 April 2013 the PRA) as to the steps necessary to improve its capital position. While it did hold capital above its ICG, it should have been apparent to Co-op that this was a misleading statement.

In addition, there was no reasonable basis for stating that the Co-op had adequate capital in the most severe stress scenarios. This was particularly the case given the significant changes in what was known about the Co-op's financial position in the previous months. This same sentence had already been removed from another section of the financial statements after concerns were expressed about its accuracy.

On 24 April 2013, the Co-op withdrew from the potential purchase of branches from Lloyds Banking Group (known as Project Verde). On 9 May 2013 the credit agency, Moody's, downgraded the Co-op's debt ratings from A3/Prime 2 to Ba3/Not Prime (a downgrade of 6 levels). This resulted in a significant drop in the value of the Co-op's listed securities.

The Co-op announced it was holding insufficient capital on 17 June 2013 and required an additional £1.5bn of Common Equity Tier 1 (CET1) capital. The PRA confirmed in an announcement on 20 June 2013 that it was also of the view that the Co-op had a £1.5bn capital shortfall.

During 2013, the Co-op carried out a liability management exercise, with the aim of increasing the level of capital that it held by £1.5bn. This exercise involved issuing new shares and new debt in exchange for cash and existing debt and preference shares. The value of holdings was significantly reduced when this exercise completed on 20 December 2013.

The Co-op's breach of principle 11 by failing to notify the FCA of intended changes to two senior positions (and the reasons behind those changes) was also a serious failing. The FCA would expect to be notified of any intended changes to senior individuals without delay to enable it to properly consider and assess the management of the firm. This is particularly important when, as was the case with the Co-op in the relevant period, there were significant issues to be dealt with by the firm.

What is the background to the PRA censure?

The reasons for the PRA's issuance of the final notice and public censure were drawn from the same facts, but the PRA had a different focus. The PRA held that for the period 22 July 2009-31 December 2013, the Co-op breached principles 3 and 11.

The PRA held that, between 2009 and 2013, the Co-op had failed to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management controls, in breach of principle 3. The Co-op's 'three lines of defence' model had failed in the following respects:

- there had been no appropriate management oversight, which resulted in a failure properly to consider risk--in particular in the corporate loan book
- assumptions had been changed in respect of the Leek Notes--and senior management had not been notified of this change
- despite adopting a cautious appetite for risk, the Co-op failed to follow its own risk appetite
- the second line of defence (risk and compliance) provided no independent challenge to these failings, and

- the third line of defence (internal auditing) did not pick up on key issues and failed to focus on high-risk areas

The PRA also identified that senior management had not been kept informed of various changes within the Co-op. For example:

Change of assumption

The change of assumption in July 2009 as to when Leek Notes would be redeemed, was not adequately communicated to the board on a timely basis and the board was not asked to approve this decision before it was made, despite its significant capital and market reputational implications.

Material adverse change (MAC) clause

The board was not notified of a potential triggering of a MAC clause in the Britannia merger deal. The MAC clause gave both the Co-op and Britannia the ability to withdraw from the merger in certain specified circumstances. One of these specified circumstances was if Britannia's capital headroom, relative to its capital requirements, fell below £100m prior to completion. The potential for this trigger to be met arose from Britannia buying back subordinated debt and redeeming Leek Notes, together with a continuing depreciation in the asset value and deterioration of the business plan. These matters were not escalated to the board, despite their potential to trigger the MAC clause and the implication that the Co-op would need to focus carefully on capital post-merger.

The PRA's final notice sets out a series of failings in relation to policies, procedures and management structure. It considers that the Co-op put the short-term financial position of the bank ahead of, and at the cost of, long-term prudence.

Why is the enforcement action particularly newsworthy?

Although part of the regulatory toolkit, public censures are rarely used by financial regulators. What is particularly notable is that, despite the size and reputation of the Co-op, neither the PRA nor the FCA wished to impose a monetary fine upon the Co-op. It seems that the reasoning of the regulators was threefold:

- the breaches, although very serious, were as a result of negligent actions, rather than deliberate acts
- no profits were made from the wrongdoing, by the Co-op Bank
- most importantly, it appears, the regulators had regard to the potential impact of a financial penalty upon the Co-op

The new board has put in place a five-year turnaround plan with the aim of ensuring that the Co-op meets its ICG on a sustainable basis and has adequate capital to withstand a severe stress. Management systems and controls are also being overhauled. The imposition of a £120m fine would be a major setback to such plans, which the regulators would not (one would assume) wish to derail. Both regulators noted in their final notices that had paid 'particular' regard to the impact of a financial penalty in deciding, instead, to issue a public censure.

What lessons can be learned by firms as a result of the enforcement action?

The saga of the Co-op is a sorry tale. Arguably, the Britannia merger ought not to have taken place, had the board been properly informed of the liabilities Britannia held at the time. The Co-op's capital difficulties, coupled with high-profile departures of senior members, have left the new board with considerable work ahead.

Of course, it is crucially important for regulated firms to maintain the proper systems and controls, and to ensure that financial statements are accurately reported to the public under the Listing Rules and to be open and cooperative with their regulators. However, what is perhaps most interesting about both regulators' positions is the enforcement action they decided to both take and not to take. This demonstrates that where a firm, which has committed a breach of either a rule or principle, finds itself the subject of enforcement action, it may be able to negotiate a censure rather than a fine, if to impose a fine would cause significant financial hardship or would derail the amends that the firm has been making to remedy the breach. Ironically, the Co-op's serious failings did not result in a fine because such failings were so serious that the regulators would not wish to jeopardise the precarious capital position of the Co-op with such a penalty.

What advice should lawyers give their clients?

Regulated firms should undertake checks to ensure that their management systems and controls and corporate governance structures operate as they should. This is all the more important if a firm is undergoing a period of change, or a merger or acquisition. Firms should consider carefully statements made in their accounts, in light of all the information known to them. Finally, as has been indicated, a firm that finds itself the subject of enforcement action should consider whether it can negotiate a censure rather than be faced with a penalty. The regulators appear more willing to allow this where the breaches were not deliberate, no profit was made from the breach, and the impact of a financial penalty would be severe.

Interviewed by David Bowden.

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