

---

## FINAL NOTICE

---

To: **David Baker**

Date of birth: 2 May 1953

Date: 13 April 2010

**TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS (the FSA) gives David Baker final notice about a requirement to pay a financial penalty and a full prohibition.**

### **1. THE PENALTY**

1.1 The FSA gave David Baker a Decision Notice dated 9 April 2010 which notified him that pursuant to sections 56 and 66 of the Financial Services and Markets Act 2000 (the Act) the FSA had decided to impose a financial penalty on him in the amount of £504,000 and a full prohibition.

1.2 The level of the penalty reflects:

(1) Mr Baker's agreement to settle at an early stage of the FSA's investigation. He therefore qualified for a 30% (stage 1) reduction in penalty, pursuant to the FSA's executive settlement procedures. Were it not for this discount the FSA would have imposed a financial penalty in the amount of £720,000.

1.3 Under the terms of the Settlement Agreement dated 28 February 2010, Mr Baker agreed to waive and not to exercise his rights to refer the matter to the Financial Services and Markets Tribunal once a Decision Notice had been issued.

1.4 Accordingly, for the reasons set out below, the FSA imposes a financial penalty on Mr Baker in the amount of £504,000.

## **2. REASONS FOR THE ACTION**

2.1. The FSA decided to take this action as a result of Mr Baker's misconduct as an approved person, under section 59 of the Act, at Northern Rock Plc (NR/the Firm).

2.2. During the period January 2004 to March 2008 (the Relevant Period), Mr Baker was approved to perform controlled function 1 (Director) until 16 November 2007 and from 27 November 2007 to 2 May 2008 he then performed controlled function 29 (Significant Management), both significant influence functions, at NR. Until February 2007, one of Mr Baker's reporting lines and therefore one area in relation to which he had controlled function responsibility, included the Debt Management Unit (DMU). Among other matters, the functions of DMU included the management and recovery of the secured loan book.

2.3. During the Relevant Period, Mr Baker's conduct fell short of the FSA's regulatory standards for approved persons. Mr Baker's conduct demonstrated a lack of integrity and he is therefore considered not fit and proper to perform any controlled function in relation to any regulated activity carried on by any authorised person, exempt person or exempt professional firm. Mr Baker breached Statement of Principle 1 of the Statements of Principle for Approved Persons contained in the High Level Standards part of the FSA's Handbook entitled "Statements of Principle and Code of Practice for Approved Persons" (APER). In particular:

- (1) despite becoming aware in December 2006 that there were 1,917 loans omitted from the impaired loan figures (loans reported as being either "3 months plus" in arrears or in possession), which formed part of the management information and subsequent communications made to the market, Mr Baker did not escalate this information satisfactorily nor make any formal record that this issue had arisen;
- (2) he agreed on a course of action to deal with the position which was not transparent and did not have immediate effect; and
- (3) he made misleading statements regarding the impaired loans to external

stakeholders, including market analysts, quoting figures which he knew were not a true representation of NR's impaired loans.

2.4. Mr Baker's failures in this regard are serious because:

- (1) he was Deputy Chief Executive of a large retail bank with responsibility for accurate internal and external reporting;
- (2) during the Relevant Period he had controlled function responsibility for the DMU;
- (3) had the 1,917 loans remained in the Firm's reported arrears, the figure reported in the 2006 annual accounts would have been 0.68% of the loan book instead of 0.42% (at a time when the reported Council of Mortgage Lenders (CML) average was 0.89%). If the 1,917 loans had been included in the reported possessions, the stated possessions figures would have increased from 662 cases to 2579 cases; and
- (4) accordingly, incorrect statistics relating to the impaired loans were used by NR, external stakeholders, the market and the FSA as an indicator in assessing asset quality. The impact of this cannot be quantified.

### **3. RELEVANT STATUTORY PROVISIONS**

- 3.1. The FSA's regulatory objectives, set out in section 2(2) of the Act, include the maintenance of market confidence.
- 3.2. Under section 66(1) of the Act, the FSA may impose a financial penalty on an approved person if he is guilty of misconduct and if the FSA is satisfied that it is appropriate in the circumstances. Section 66(2)(a) provides that a person is guilty of misconduct if, whilst an approved person, he has failed to comply with a statement of principle issued under section 64 of the Act.
- 3.3. Section 56 of the Act enables the FSA to make an order prohibiting an individual performing a specified function or any function falling within a specified description, if it appears to the FSA that the individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person, exempt person or exempt professional firm. The order may relate to a specified regulated

activity, any regulated activity falling within a specified description or all regulated activities.

### **Statements of Principle and Code of Practice for Approved Persons**

- 3.4. The FSA's Statements of Principle and Code of Practice for Approved Persons are issued by the FSA pursuant to section 64 of the Act. Statement of Principle 1 states that:

*“An approved person must act with integrity in carrying out his controlled function.”*

- 3.5. APER 4.1 sets out descriptions of conduct which, in the opinion of the FSA, do not comply with Statement of Principle 1. This includes (but is not limited to) deliberately failing to inform (without reasonable cause) a firm of the fact that their understanding of a material issue is incorrect (APER 4.1.6E).

## **4. FACTS AND MATTERS RELIED UPON**

- 4.1. NR is a retail bank currently in public ownership. It de-mutualised in 1997 and entered the FTSE 100 in 2000. During the Relevant Period NR experienced sustained growth and by the end of 2006 was the fifth largest UK mortgage lender with 8.3% of the residential mortgage market. Important to the Firm's rapid growth was the maintenance of its asset quality. The value of NR's securities was in part derived from a market perception of how its loan book was performing. The provision of accurate data, internally and externally, concerning the number of loans in arrears and/or possession was, therefore, an important indicator in assessing the Firm's asset quality.
- 4.2. During the Relevant Period staff within the DMU perceived that they were under pressure to maintain the Firm's reported arrears and possessions figures at half of the CML average. In order to maintain lower reported arrears and possessions figures, the DMU took a series of actions outside of Firm policies which improperly reduced the number of reported impaired loans. As it became more difficult to maintain the arrears figures, additional action was taken to achieve their targets. Further processes gave rise to a class of loans which were in default, being neither recorded in the arrears nor in the possessions figures (the “pending possessions” issue, described more fully below). The FSA has no evidence that Mr Baker were aware of, or engaged in, the

improper action undertaken within the DMU with the exception of the pending possessions issue, which he became aware of for the first time at the end of December 2006.

### **Pending possessions**

- 4.3. In 2005, loans where a possession order had been made but where physical possession of the mortgaged property had not yet been obtained were removed from the arrears figures. The DMU also regarded these loans as not being in “actual possession”. As a consequence from 2005 onwards, loans pending possession were not reported in either the arrears or possessions figures and were thus excluded from all reported data for impaired loans.
- 4.4. At the time the decision was taken in 2005 to remove the pending possession cases from the reported arrears, the number of such cases was minimal. However the number of pending possessions increased in the second half of 2006.
- 4.5. Although Mr Baker first became aware from around December 2005 that pending possessions were not being reported in the arrears figures, he believed they were reported in the possession figures. He was informed for the first time in late December 2006 by way of an oral report from a member of staff within the DMU that this understanding was incorrect. He investigated the matter in early January 2007 and verified that the cases were indeed omitted from the possession figures and that by that stage 1,917 cases were not reported.
- 4.6. Upon receiving confirmation that the 1,917 cases were not included in the possessions data, Mr Baker sought and obtained confirmation from a senior and suitably qualified colleague that the pending possessions cases had been appropriately accounted for in the bad debt provisions. That colleague also expressed the view that there was no obligation to amend statements in the annual 2006 accounts which were about to be published. Based on these discussions and in agreement with that colleague, he resolved to address the backlog of pending possession cases by increasing resources to the DMU to obtain possession in these cases and thus actively bring the cases into the reported possession numbers over a six month period.
- 4.7. Despite Mr Baker’s awareness of the mis-reporting of pending possessions by January

2007, he decided not to escalate the matter further. In particular he did not inform the Firm's Chief Executive or the risk management committee. Mr Baker made the decision not to disclose the correct position immediately on compassionate grounds because he believed the likely result would have been either dismissal or other serious disciplinary consequence against a DMU employee. He believed that disciplinary action of this nature would have been disproportionate.

- 4.8. However, in making this decision Mr Baker was aware that the reported data in respect of impaired loans stated in the Operating and Business Review for the 2006 annual accounts would be incomplete since it did not include the pending possession cases.
- 4.9. In arriving at this decision Mr Baker placed too much emphasis on the employee's personal circumstances and Mr Baker's perception of the likely reaction of the Firm to the situation. He did not place enough emphasis on the need for timely internal reporting of pending possession cases, and the consequences of this in terms of external reporting. He now accepts that priority should have been given to the accuracy of the reporting of the pending possession cases prior to the publication of the Firm's accounts.
- 4.10. From February 2007, Mr Baker no longer had Controlled Function responsibility for the DMU. The implementation of the plans to resolve the backlog of pending possessions cases was, therefore, not Mr Baker's direct responsibility. However, he continued to act as Chairman of NR's Assets and Liabilities Committee. In that capacity he received management information which he knew to be incorrect. Mr Baker took no steps to satisfy himself that the position in relation to the accounts shown in possession had been corrected in the time frame agreed. In the event, the reported possessions figures were still incorrect when the interim accounts were published in July 2007, although pending possessions were by that stage down to 828 cases.

## **Comments to the market and external parties**

4.11. On 24 January 2007, Mr Baker participated in a webcast to the market discussing the Firm's 2006 accounts. He stated that NR's arrears levels were less than half the CML average, attributing this to improved collections and improved front end risk underwriting processes. He also stated that possession figures were exceptionally low at only 600 given the size of the Firm's loan book. Mr Baker in fact knew that the reported data in respect of impaired loans stated in the Operating and Business Review for the 2006 annual accounts was low because 1,917 pending possession cases had not been reported.

## **5. BREACHES**

5.1. In performing his controlled functions, Mr Baker's conduct fell short of the FSA's regulatory standards for Approved Persons. In particular, Mr Baker breached Statement of Principle 1 in that he failed to act with integrity in carrying out his controlled functions because:

- (1) when he was informed that 1,917 cases had been omitted from the possessions figures, he did not escalate this information to the Chief Executive, the board or the risk management committee, nor make any formal record that this issue had arisen;
- (2) Mr Baker agreed on a course of action which was not transparent and did not have immediate effect;
- (3) he knew that the reported possessions figures in the Operating and Business Review for the 2006 accounts were incomplete as they did not include the pending possession cases; and
- (4) as a result Mr Baker made misleading statements to external parties and in particular to market analysts.

5.2. By reason of Mr Baker's misconduct as described above, the FSA also considers that Mr Baker is not a fit and proper person to perform any functions in relation to any regulated activities carried on by any authorised person, exempt person or professional firm.

## **6. ANALYSIS OF THE PROPOSED SANCTION**

### **Prohibition**

- 6.1. The FSA has had regard to the guidance in Chapter 9 of EG in deciding that a Prohibition Order is appropriate in this case.

### **Financial penalty**

- 6.2. The FSA considers it appropriate to impose a financial penalty against Mr Baker in accordance with EG 9.23.
- 6.3. The FSA has taken all of the circumstances of the case into account in deciding that the imposition of a financial penalty is appropriate and the level of the penalty imposed is proportionate. The FSA's policy in relation to the imposition of financial penalties is set out in Chapter 6 of the Decision Procedure and Penalties Manual (DEPP) which forms part of the FSA Handbook. It was previously set out in Chapter 13 of the Enforcement Manual (ENF).
- 6.4. These Manuals set out the factors that may be of particular relevance in determining the appropriate level of financial penalty for a firm or approved person. The criteria are not exhaustive and all relevant circumstances of the case will be taken into consideration.

### **Deterrence**

- 6.5. The FSA considers that the imposition of a financial penalty will promote high standards of regulatory conduct by deterring approved persons from acting in this way.
- 6.6. In determining the appropriate level of penalty, the FSA has had regard to Mr Baker's conduct in the performance of his controlled function. The need to ensure those who are approved persons act with integrity has been taken into account. The FSA considers that a significant penalty should be imposed to demonstrate to Mr Baker and others the seriousness with which the FSA regards this behaviour.

### **The nature, seriousness and impact of the breach: DEPP 6.5.2G(2)**

- 6.7. The FSA considers that Mr Baker's breach of Statement of Principle 1, is of a



particularly serious nature. The impact of the failure to report the 1,917 impaired loan accounts is set out at paragraph 2.4(3) above.

**The extent to which the breach was deliberate or reckless: DEPP 6.5.2G(3)**

- 6.8. The FSA considers that Mr Baker's failure to escalate the issues he discovered to internal and external parties from at least late 2006, the incorrect treatment of pending possessions and, from January 2007, misleading statements he made to the market, were deliberate.

**Whether the person on whom the penalty is to be imposed is an individual: DEPP 6.5.2G(4).**

- 6.9. The FSA has taken into account the fact that, as an individual, the imposition of a financial penalty is likely to have a significant impact on Mr Baker. The FSA considers the imposition of a financial penalty to be proportionate and appropriate in relation to the seriousness of the misconduct, especially in view of the seniority of his position at the Firm. Mr Baker's role included ensuring that business was conducted in full compliance with all applicable laws, regulations and codes of practice.

**The financial resources and other circumstances of the person: DEPP 6.5.2G(5)**

- 6.10. There is no evidence to suggest that Mr Baker would be unable to pay the proposed financial penalty.

**The amount of benefit gained or loss avoided: DEPP 6.5.2G(6)**

- 6.11. NR operated various performance related bonus schemes, by which senior staff and directors acquired shares in the Firm which were referable to annual bonuses awarded by the Firm. The scheme required that shares allocated pursuant to the scheme must be held for a minimum of three years. In the normal course, the scheme operated so that each year, bonuses awarded by the Firm were automatically used to purchase shares, which were held for three years. Pursuant to the terms of the scheme, shares could only be bought or sold during prescribed periods.
- 6.12. One such prescribed period in which such a share sale took place was in January 2007. On 27 January 2007, Mr Baker and his family sold shares referable to bonuses he had been awarded in or prior to 2003. This was three days after the webcast had

occurred, during which he made misleading statements to the market. However, pursuant to the scheme, allocations of shares also took place referable to Mr Baker's 2006 bonuses: he was allocated more shares than sold. The allocations were made at a time when the inaccurate possession numbers remained uncorrected in the public domain. The shares he sold were at the same price as those that were allocated to Mr Baker under the bonus scheme. Taking all these transactions into account, the FSA accepts that there is no evidence of financial benefit to Mr Baker arising from his misconduct, nor is there evidence that this was a motivating factor in his misconduct.

**Conduct following the breach: DEPP 6.5.2G(8)**

- 6.13. The FSA recognises that Mr Baker co-operated with the FSA's investigation and made a number of admissions in relation to his misconduct.

**Disciplinary record and compliance history: DEPP 6.5.2G(9)**

- 6.14. The FSA has not previously taken any disciplinary action against Mr Baker.

**Previous action taken by the FSA: DEPP 6.5.2G(10)**

- 6.15. The FSA seeks to ensure consistency when it determines the appropriate level of penalty and has taken into account previous decisions made in relation to similar misconduct by approved persons.

**Other points in mitigation**

- 6.16. The FSA has noted that the DMU was one of a number of business units for which Mr Baker had responsibility and that he placed reliance on senior management in each of the business units to manage them effectively and to report serious issues to Mr Baker.
- 6.17. Mr Baker has represented to the FSA that at this time he felt overburdened and by January 2007 he was taking steps to reduce his workload by obtaining further assistance and by moving some of his reporting lines to other people. This included the DMU which passed from his control in February 2007.

6.18. The FSA also notes that Mr Baker has had a career of over 30 years in the regulated sector and he has not previously been the subject of regulatory action.

## **7. CONCLUSION**

7.1 Having regard to the seriousness of the breaches and the risks they posed to the FSA's statutory objective of maintaining confidence in the financial system, the FSA has made a Prohibition Order against Mr Baker and imposed on him a financial penalty of £504,000. It is necessary and proportionate to impose a financial penalty to promote high standards of conduct and to deter other approved persons from acting in this way.

## **8. DECISION MAKERS**

8.1. The decision which gave rise to this Final Notice was made by the Settlement Decision Makers on behalf of the FSA.

## **9. IMPORTANT**

9.1. This Final Notice is given to Mr Baker in accordance with section 390 of the Act.

### **Manner of and time for Payment**

9.2. The financial penalty must be paid in full by Mr Baker to the FSA by no later than 27 April 2010, 14 days from the date of the Final Notice.

### **If the financial penalty is not paid**

9.3. If all or any of the financial penalty is outstanding on 28 April 2010, the FSA may recover the outstanding amount as a debt owed by Mr Baker and due to the FSA.

### **Publicity**

9.4. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such

publication would, in the opinion of the FSA, be unfair to Mr Baker or prejudicial to the interests of consumers.

**FSA contacts**

9.5. For more information concerning this matter generally, contact Bill Sillett (direct line: 020 7066 5880 / fax: 020 7066 0175) of the Enforcement and Financial Crime Division of the FSA.

**William Amos**

**FSA Enforcement and Financial Crime Division**