

# Financial Services Authority

**From the Chairman  
Adair Turner**

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Andrew Tyrie MP  
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Our Ref: CW

Dear Andrew

Two weeks ago you raised the issue of whether the involvement of an external reviewer in the forthcoming FSA report on RBS would be useful to provide reassurance that the FSA was being fully open about any deficiencies in its own effectiveness relating to the matters in question. Since then you and I have had a number of discussions. In the course of these, and following advice from the FSA's General Counsel, I raised the separate possibility that the PWC report to the FSA, which was an input to the FSA's Enforcement decisions, could be provided to Parliament and published under parliamentary privilege.

I have also discussed these issues with the FSA Board: and I have had a conversation with Sir David Walker, whom we both considered might be an appropriate person to conduct an external review.

In this letter I would like to propose a way forward. The essential points are:

- I think the external review idea is a very good one. Indeed I wish I had thought of it back in December. Even at this stage, however, I think we should go ahead with it, but with the inevitable consequence that publication would have to be delayed. Sir David Walker is happy to play this role: I think he would be an excellent choice;
- following further discussions with both our General Counsel, Andrew Whittaker, and our Head of Enforcement, Margaret Cole, I strongly advise that, while it appears legally possible for the PWC report to be published under parliamentary privilege, that it should not be. This is because such action could potentially prejudice the effectiveness of future FSA (or successor body) enforcement investigations.

I set out below:

1. where we have got to with the RBS reports;

2. the potential role of an external reviewer, implications for timetable and process to get arrangements in place;
3. arguments against using parliamentary privilege to publish the PWC report.

## **1. Progress on RBS reports**

We are now well advanced with the work required to produce two linked reports.

The Enforcement Report. This seeks to explain the basis for the decisions made by the FSA's Enforcement Division following investigation of three specific sets of issues (i) management controls and decision-making process at Global Banking and Markets (GBM) (ii) the set of decisions relating to the acquisition of ABN AMRO (iii) investor communications at a number of crucial points.

The report explains why our Enforcement Division believed that these were the areas most worthy of investigation. It summarises the evidence which was gathered in the course of these investigations (both via PWC and through interviews conducted by our enforcement lawyers). And it explains why the Enforcement Division reached the conclusion that there was not sufficient evidence to bring enforcement action which, on the balance of probability, would be likely to be successful.

This report is being produced by members of our Enforcement Division, subject to my challenge and questioning. It will also now be reviewed by a sub committee of FSA Non Executive Directors. It is currently in draft form, and is now being reviewed by lawyers representing RBS and other interested parties. Those lawyers may challenge some of our conclusions and the inclusion of some evidence, given that all of the evidence on which the report draws is subject to legal constraints on publication. It is possible, though at this stage unclear, that those lawyers may request that some bits of the report are redacted.

The Supervision Report. This report looks at the effectiveness of the FSA supervision of RBS between 2005 and end April 2008. The period between 2005 and April 2008 has been chosen using the same logic as we applied to our Northern Rock Internal Audit report. The date of failure of RBS is judged to be 7 October 2008 when it received support from the Bank of England. However our view is that once the rights issue was completed in April 2008, there was no scope for further supervisory interventions which could have prevented the failure in October.

The report sets out how the FSA supervised RBS in respect to (i) capital, asset quality and liquidity (ii) the rapid growth of GBM and the acquisition of ABN AMRO, both of which were highly relevant to the bank's subsequent failure (iii) RBS's management style, governance, and culture.

This report, although not an internal audit report, has been led by Rosemary Hilary, the FSA's Head of Internal Audit, who also conducted the widely respected internal audit report on Northern Rock, which identified and publicly admitted major failures in the FSA's approach and effectiveness. I have spent considerable time challenging the team and

reviewing directly key pieces of relevant evidence, to ensure that we have identified all key issues and deficiencies. The report is very clear that there were major deficiencies in both the rules the FSA applied and its supervisory practices with regards to large systemically important banks in the pre-crisis period.

An initial draft of this report has now been produced. It is over 100 pages long. It is now being reviewed by RBS lawyers, and is subject to the same process of legal challenge which applies to the Enforcement review. This is because much of the supervisory information on which it is based cannot be disclosed without the firm's approval.

These two reports will be supplemented by:

- an overall account of why RBS failed;
- a short Summary of Conclusions Report which will set out the overall lessons learned and any recommendations for future policy changes, whether in bank regulation and supervision, or in the role which enforcement actions play, relative to other sanctions and incentives, in ensuring appropriate senior management and board focus on risk control.

All these reports could be ready for publication in early May, following consideration by a sub committee of FSA NEDs and discussion at the FSA Board on April 28.

## **2. The role of an External Review**

The issue you have now raised, however, is whether the involvement of an external reviewer would add value to this process, specifically by providing external assurance that the FSA is being brutally honest about any of its own failings. I agree it would. While I am absolutely confident of the determination of our review team to be scrupulously open about what they have found, and while I, to whom the team is reporting, am not conflicted since not at the FSA at the relevant time, there is always a value in additional transparency and assurance of independence. I wish that one of us had thought about the idea of an external reviewer when the FSA committed to produce these reports back in December.

But I agree that it would be valuable now to put such a process in place, asking a senior respected person, with appropriate support, to review the processes we have followed.

Obviously we would need to be very clear about the remit of such an external review, identifying both what it would do and would not do. I propose the following:

### Enforcement Report

The external review would:

- provide assurance that our summary account of evidence is fully compatible with and reflects the key findings of the underlying PWC evidence and any other relevant evidence. It would provide assurance that we have not excluded from our summary

account any key findings which would have a bearing on whether there was a case for enforcement action;

- if the review felt appropriate, comment on whether the evidence reveals deficiencies in corporate governance which, while not enforceable against under existing rules, imply the need for changed practices or rules.

It would not:

- express a legal point of view on whether we were right to focus enforcement on the specific issues selected. Our report itself will set out clearly the logic of why we selected those issues, and the external world will then be able to judge whether that appears a sensible focus;
- express a legal point of view on whether enforcement were right to reach the conclusion that on the balance on probability there were not winnable enforcement cases (other than the negotiated case with J Cameron). The Summary of Conclusions will explain that that was the professional judgment of enforcement: and the report itself will explain the factors which led Enforcement division to reach that conclusion.

### Supervision Report

The external review will:

- review the rigor and comprehensiveness of our review of the FSA's supervision of RBS, while recognising that this review has been based for the most part on sources of information available within the FSA (and not for example on newly conducted interviews with relevant executives or non executives at RBS);
- provide reassurance that the FSA's supervisory report has sought to identify and has identified any key deficiencies in supervisory approach, and has not failed to reveal key issues and deficiencies for reasons of defensiveness. This reassurance would be achieved both by looking at the rigour and comprehensiveness of the process, and the checks and balances involved: and via selective detailed analysis of key documents and events.

The external review will not:

- set out conclusions on the implications for regulatory and supervisory policy. That will be done in the report itself and in the Summary of Conclusions.

The external review would take into account the fact that our review of supervisory effectiveness focuses on issues specific to RBS, and on possible failings in process beyond those already identified in the Northern Rock Audit report, and has therefore not duplicated analysis and recommendations covered by that report.

Clearly we would need to agree this mandate, the working procedure, and the required timetable with the external reviewer once selected. But my proposals would be that:

- the process will need perhaps two months. It could start in mid April, at which stage we would have draft reports which had already gone through the initial process of legal challenge. Sir David Walker or any other independent reviewer will need to satisfy themselves about how long they will need, but our aim will be to agree a timetable which allows publication of the report and delivery to the Treasury Select Committee in good time before the summer recess;
- the external reviewer would produce some sort of external report – a summary statement of his/her conclusions on the effectiveness of our processes and the reasonableness of our conclusions;
- but equally important to any external reviewer's report, would be an ongoing process of challenge to the team, (including to me and to the NED sub committee) to suggest issues and areas of evidence on which we might focus further attention, producing improvements to the FSA's reports before publication.

As I mentioned above, and as agreed with you, I have already discussed these ideas in outline with Sir David Walker, and he is happy to play this role.

I think the next steps to progress this issue are (i) for you to confirm that the TSC would consider that Sir David Walker would be an appropriate person to fulfil this role (ii) we would then enter detailed discussions with Sir David about appropriate working process, analytical support, and timetable (iii) we should then coordinate press statements from both you and us to explain what is occurring.

I am away on holiday next week, but Hector can progress issues in discussion with you and Sir David (if appropriate) during my absence, and I can be on the phone to discuss key issues.

I think we should aim to get the details pinned down and ready to announce them during the week of April 4.

### **3. Publication of the PWC Report under Parliamentary Privilege**

I have discussed carefully with our lawyers the separate issue of whether it would be appropriate for you to request and for us to send you a copy of the PWC reports, which you could then publish under parliamentary privilege. My recommendation is that we should not.

I should first be clear what we are talking about. There are three different PWC reports, covering evidence relevant to the three investigations mentioned above (see Section 1 of this letter). They set out evidence drawn from documents and interviews which was then considered by lawyers in our Enforcement Division as an input to their professional judgment on the likelihood that enforcement actions would be successful.

The reasons we believe that these reports should not be published are that:

- publication could prejudice the effectiveness of the FSA and its successor bodies in future enforcement actions. Parties subject to enforcement work potentially face

serious financial sanctions and banning orders affecting their livelihoods. Often they also face collateral risk in the form of private litigation. These actions therefore entail the gathering of evidence on the basis of confidentiality protected by statute [FSMA] and European law. If Parliament were to use parliamentary privilege to override these normally applicable constraints, people who are being interviewed in future investigations (whether as potential defendants in enforcement cases or as witnesses) could be influenced by the awareness that the normally applicable confidentiality arrangements could be overridden;

- if the reports were to be published, it would be normal and right to give both the firms and the individuals referred to an opportunity to make representations about the facts found and conclusions drawn, given that the reports may involve significant explicit or implicit criticism of them. Had we decided to proceed with Enforcement cases, this process of representation that would have occurred. When we decide that there is not sufficient evidence of action contrary to rules to bring a successful enforcement case, however, we do not go through that process, since the evidence collected will in any case remain confidential;
- in essence the main point is that it is not normal practice for any prosecuting authorities to publish the material which led to a decision not to prosecute, and there are major issues of principle to be considered if we now find a way to override the normal practice.

While therefore the legal advice is that the TSC would have the power to request the documents, and to publish them under parliamentary privilege if it wished, our judgment is that this would not be in the long term public interest, particularly if we have put in place another mechanism (through the external review process) to provide reassurance that our Enforcement Report is a good summary of the balance of evidence available in the PWC reports.

We should note, however, that we do not need to reach any final decisions relating to the PWC report in order to progress arrangements for the External Review. I suggest therefore that we now rapidly progress to put those arrangements in place, and if necessary deliberate further on the PWC reports.

I look forward to discussing these issues with you and to ensuring that we can publish transparent and valuable reports.

Yours sincerely

A handwritten signature in black ink that reads "Adair Turner". The signature is written in a cursive, flowing style with a large initial 'A'.

**Adair Turner**