Mr Andrew Tyrie  
Chairman  
Treasury Select Committee  
House of Commons  
Millbank  
SW1P 3JA

Andrew Bailey  
Deputy Governor  
Prudential Regulation Authority  
Bank of England

19th December 2013

Dear Andrew,

In its final report, Changing Banking for Good, the Parliamentary Commission on Banking Standards recommended that the PRA and FCA should provide to the Treasury Select Committee a considered response to the risk that they may appear to act as shadow directors of the firms they regulate.

The attached note is the PRA’s response to this recommendation. The note addresses the question in the context of the statutory role of the PRA and the judgement-based, forward-looking approach to the discharge of its supervisory responsibilities which was set out in the approach documents we published in April 2013. It concludes that as a matter of law, the actions that the PRA takes in the proper discharge of its statutory duties would not result in it being regarded by the courts as a shadow director.

However, we recognise the importance that our responsibilities are discharged in a manner that does not blur the responsibility of boards and management for the running of their firms, and that does not unnecessarily narrow the scope for management to consider commercial options to respond to regulatory issues. This is in line with the emphasis the PRA has placed in its approach documents on the responsibility of each firm’s board and management to manage the firm prudently, consistent with its safety and soundness. But the note also explains that the PRA must be ready and able to intervene proactively and early enough to meet potential or emerging problems with the safety and soundness of firms, for which it has been given a broad range of regulatory powers. In order to discharge its responsibilities in a timely and responsible manner, it is right that the PRA should take action from time to time which will constrain or direct the actions of the boards and senior management of the firms it regulates.

I understand that the Committee will probably wish to publish this note and we are of course happy for you to do so.
I am copying this letter to Martin Wheatley at the FCA.

Yours sincerely,

Andrew Bailey

Cc: Martin Wheatley, Financial Conduct Authority
APPEARING TO ACT AS A SHADOW DIRECTOR

Note by the Prudential Regulation Authority to the Treasury Select Committee

Introduction

1. The Parliamentary Commission on Banking Standards (PCBS) in its report of June 2013, Changing Banking for Good, recommended that the Prudential Regulation Authority (PRA) should within six months publish and provide to the Treasury Select Committee (TSC) a considered response to the risk that they may appear to act as shadow directors of the firms they regulate.¹ This note is the PRA’s response.

Summary of key points

The PRA is the statutory authority charged with the prudential regulation of a range of financial institutions. It has a statutory objective to promote the safety and soundness of those firms and is required to pursue this objective primarily by seeking to avoid adverse effects on financial stability. In order to fulfil this function, the PRA has been granted wide statutory powers over the firms and individuals it regulates.

The PRA has set out its judgement-based, forward-looking approach to the discharge of its supervisory responsibilities in the approach documents it published in April 2013. These documents make clear that responsibility for running regulated firms in a sound and prudent manner rests with the board and management of those firms. And while the PRA will look to management to resolve supervisory issues, it reserves the ability to deploy its formal powers at an early stage and not merely as a last resort.

Following publication of the PCBS report, the PRA is also seeking to reinforce individual accountability and responsibility at firms through the introduction of a Senior Persons Regime.

Given the statutory basis for the PRA’s role, the PRA does not consider that actions that it takes in the proper discharge of its statutory duties could result in it being regarded by the courts as a shadow director within the meaning of section 251 of the Companies Act 2006. The concept of shadow directorship was not conceived to capture statutory authorities like the PRA, which are accountable for their actions as set out in the relevant statutes and according to the principles of public law.

Nevertheless, it is important that the PRA’s responsibilities are discharged in a manner that does not blur the responsibility of boards and management for the running of their firms nor narrow the scope for management to consider commercial options to respond to regulatory issues beyond what is necessary to ensure an adequate and timely response to those issues.

This is in line with the emphasis the PRA has placed in its approach documents on the responsibility of each firm’s board and management to manage the firm prudently, consistent with its safety and soundness. Where it is feasible to do so, the PRA will seek to leave management with discretion over how they respond to issues raised in the course of supervision.

However, it should be recognised that the PRA must be ready and able to intervene proactively and early enough to meet potential or emerging problems with the safety and soundness of firms, and has been given a broad range of

¹ Changing banking for good, Report of the Parliamentary Commission on Banking Standards (‘PCBS Report’)
regulatory powers in order to allow it do so. In order to discharge its responsibilities in a timely and responsible manner, the PRA will take action from time to time which constrains or directs the actions of the boards and senior management of the firms it regulates.

The PRA’s general objective, statutory powers and supervisory approach

2. The Financial Services and Markets Act 2000 (FSMA)\(^2\) as amended by the Financial Services Act 2012\(^3\) sets out the PRA’s general objective of promoting the safety and soundness of PRA-authorised persons, which it is required to advance primarily by seeking to:

- ensure that the business of PRA-authorised firms is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- minimise the adverse effect that the failure of a firm could be expected to have on the stability of the UK financial system and in particular, adverse effects resulting from the disruption of the continuity of financial services.

The PRA also has a statutory objective to protect insurance policy-holders.

3. As the body tasked by Parliament with promoting the safety and soundness of PRA-authorised persons, the PRA has wide statutory powers over the firms and individuals it regulates, including the power to:

- grant, refuse, vary or cancel permission to carry out PRA-regulated activities, such as accepting deposits, or place constraints or requirements on the way in which a particular type of business is undertaken where this is desirable to advance its objectives;
- grant, refuse or cancel approval for individuals to carry out PRA-controlled functions – the present Approved Persons Regime is due to be replaced with Senior Persons and Licensing Regimes in accordance with recommendations of the PCBS report; and
- take a variety of enforcement action, including imposing penalties, against authorised firms or individuals.

4. In exercising its powers, the PRA must ensure that the firms it supervises satisfy the threshold conditions set out in Schedule 6 of FSMA and that individuals authorized as approved persons are fit and proper as required by section 61 of FSMA (by reference to, among other things, the Threshold Conditions)\(^4\) and observe the Statements of Principle and Code of Conduct for Approved Persons in the APER section of the PRA Handbook.\(^5\)

5. In April 2013, following its establishment as the prudential regulator for banks, insurance companies and systemically important investment firms, the PRA published two approach documents, one


\(^3\) [http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted](http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted)


for banks and designated investment firms and the other for insurance companies, setting out the PRA’s approach to the discharge of its supervisory responsibilities, drawing on the lessons of the recent financial crisis. The approach documents set out a supervisory approach based on:

- **Significant reliance on judgement**, supported by evidence and analysis. Regulatory decision-making must be rigorous and well-documented, consistent with public law; and

- **A forward-looking approach**, assessing firms not just against current risks, but also those which could plausibly arise in the future, underpinned by proactive intervention. Where the PRA judges it necessary to intervene, it generally aims to do so at an early stage.

6. The approach documents make clear that the responsibility for running the regulated firms in a sound and prudent manner rests with the board and management of those firms.

7. The approach documents also make clear that the PRA looks to firms to co-operate with it in resolving supervisory issues, but will not hesitate to use formal powers where it considers them to be an appropriate means of achieving its desired supervisory outcomes. In certain cases, the PRA will choose to deploy formal powers at an early stage and not merely as a last resort.

8. This emphasis on the individual accountability and responsibility of the boards and senior management of firms will be further reinforced through the introduction of a new Senior Persons Regime, as recommended by the PCBS. Under the proposed new regime, those subject to it will be subject to a reverse burden of proof whereby they would be required to demonstrate that they had taken all reasonable steps to prevent or mitigate the effects of a specified failing in the event of enforcement action against a firm. It is also expected to be supported by a new criminal offence of reckless misconduct in the management of a bank.

Acting as a Shadow Director

9. Section 251 of the Companies Act 2006 defines a shadow director as a person in accordance with whose directions or instructions the directors of the company are accustomed to act. Shadow directors do not necessarily owe the company the full range of duties owed by other directors; their duties will depend on their position and functions. Case-law has elaborated on the definition of a ‘shadow director’, which is expected to be widely construed and can potentially capture any individuals (other than professional advisers) on whose directions a majority of the board is accustomed to acting.

10. However, the PRA is a statutory authority, with objectives and wide powers set in statute, including the specific ability to constrain or direct the range of business undertaken by a firm it regulates, or the manner in which, or extent to which such business may be undertaken. There is a clear expectation that the PRA should be able to exercise these powers, in a timely and proportionate manner, in the pursuit of its statutory objectives. This is why the PRA has broad statutory immunity from damages under FSMA in

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6 http://www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx
respect of actions taken in the pursuit or purported pursuit of its objectives so long as these actions are taken in good faith.

11. Given the statutory basis for the PRA’s role, the PRA does not consider that actions that it takes in the proper discharge of its statutory duties could result in it being regarded by the courts as a shadow director within the meaning of the Companies Act 2006. The concept of shadow directorship, which is aimed at people who act as directors without formal appointment as such, was not conceived to capture statutory authorities like the PRA, which are accountable for their actions as set out in the relevant statutes and according to the principles of public law, including the possibility of judicial review of its decisions.

**Getting the balance right between board responsibility and the regulator’s role**

12. The PRA recognises the importance of ensuring that the way it discharges its supervisory responsibilities does not blur the responsibility and accountability of the boards and management of firms for the conduct of the business of their firms. Indeed, one of the cornerstones of the reforms we will be undertaking in response to the PCBS report is the establishment of the Senior Persons Regime, the aim of which is to ensure that the key responsibilities within banks are assigned to specific individuals, who are made fully and unambiguously aware of those responsibilities and made to understand that they will be held to account for how they carry them out.

13. The PRA approach documents emphasise that the boards and management of regulated firms must be clear that they are answerable for their actions, no less so than the boards and management of other firms even though they are subject to additional requirements by virtue of being regulated by the PRA, and that in addition they are subject to specific responsibilities to run their business in a prudent manner, consistent with its safety and soundness, thereby contributing to the continued stability of the financial system. In particular, the approach documents set out the general expectations of those boards and managements in terms of culture and behaviour, structures and risk management and controls.

14. In the normal course of supervisory business, the PRA will mitigate any blurring of the responsibility of the board and management of firms by ensuring that:

- supervisory judgements are based on evidence and analysis and are related back to the PRA’s statutory objectives, regardless of whether formal powers are being exercised;

- the rationale for its supervisory judgements, and as far as possible the relevant information and analysis underpinning those judgements, is communicated to the board and management of the firm to inform their own decision-making; and

- where different commercial options may be open to the firm to deliver the desired supervisory outcomes, these are constrained only to the extent necessary to meet the PRA’s objectives.

15. For example, it is the responsibility of the board and management always to maintain the adequacy their firm’s capital position, to plan accordingly and to address any actual or prospective deficiencies promptly as they emerge. Where the PRA concluded that a firm needed to strengthen its capital position,
the firm would be informed of the degree of strengthening required, over what timescale, and the reasons for it, but might be left with broad discretion to decide to what extent this would be achieved through asset disposal, changes to the nature or blend of business undertaken, retention of earnings and external capital raising, except to the extent that there were practical constraints (perhaps due to the urgency of the requirement or a lack of market capacity), or certain options had to be excluded because of concerns over the potential impact on wider financial stability, e.g. a sharp contraction in lending by a major bank.

Proactive Intervention

16. Note that the PRA has emphasised in its approach documents that it will be forward-looking and that this means it may intervene proactively where justified to meet potential concerns. In such circumstances the board or management of the firm may well not share the PRA’s view of the likelihood, timing or seriousness of the identified risk, but the PRA will nevertheless require action to be undertaken on a timescale that meets its own assessment of the risk, and may need to constrain the range of management actions accordingly.

17. Although the PRA will seek to avoid unnecessary constraints on the range of management actions that may be used to meet its supervisory requirements, it is important to recognise that the range of options is more likely to be constrained the more urgent the requirement or the more serious its implications. (It may also be relevant that the existing management may be responsible for the adverse circumstances facing the firm.) It follows that where the PRA is intervening to avert the failure of a firm or a major disruption to financial stability, the more severe the stress, more imminent the failure or the closer the threat, the more directive the PRA’s response may need to be.

18. This is reflected in Proactive Intervention Framework (PIF), which was set out in the approach documents. For example, a firm at PIF stage 3 (risk to viability absent management action) will be required to take management action, drawing on the menu options identified in its recovery plan as appropriate. However, where a firm moves to PIF stage 4 (imminent risk to viability), the PRA is likely to require an increase in the scale of the recovery actions required, and will set a shorter-term timetable for implementation of those actions. The firm will be required to demonstrate that the actions it proposes to take are credible and will produce material results.

19. This is consistent with the objectives set for the PRA by Parliament and range of powers with the PRA has been provided to meet those objectives. There is a clear expectation that the supervisor should be prepared to intervene in a timely and effective manner, ready to exercise the full range of its powers as and when necessary to meet its objectives, especially to meet threats to financial stability. However, the board and management of the firm remain ultimately responsible for the firm’s recovery and that is why the PRA requires the firm to produce and own its recovery plan.
Conclusion

20. As a statutory authority acting in the proper pursuit of its statutory objectives, PRA does not consider that it would be regarded by the courts as a shadow director under the Companies Act. It is nevertheless very important that there is no blurring of the proper accountability of the boards and management of regulated firms for the running of their firms.

21. In setting out its supervisory approach, the PRA has made clear that the boards and management of the firms are and will remain accountable for running their firm in a sound and prudent manner, a message that will be reinforced in the new Senior Persons Regime and through everyday supervisory interactions with those firms.

22. The PRA will avoid imposing unnecessary constraints on management discretion over how to achieve supervisory outcomes, but reserves the ability to intervene proactively to meet current or potential future risks to its objectives and to direct the actions of management where the imminence or seriousness of a threat justifies it.

Prudential Regulation Authority
19 December 2013