



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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T

7 July 2014

Dear Andrew

Skilled Persons Reviews under s166 of the Financial Services and Markets Act 2000

Thank you for your letter dated 23 June, in which you ask for information on how the PRA uses its power to require a report by a Skilled Person under section 166 of the Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012 (FSMA). In the annex attached, we have provided responses to each of your questions. In addition, there are three specific points I would like to highlight in this covering letter.

s166 and use of our internal resources

At all times, the PRA needs to consider the balance between maintaining skilled resources on its headcount as a fixed cost and using external experts such as through the s166 mechanism. As explained more fully below, we take a number of factors into account in deciding whether to commission a s166 review. One of these factors might be that we do not have particular specialist skills in-house. On the other hand, we might have in-house expertise, but not always in sufficient numbers to enable a risk at a regulated firm to be mitigated in a timely manner. Overall, s166 is a scalable and flexible regulatory tool.

Systems and Controls around the use of s166

To ensure that s166 reports are used proportionately and are cost effective, internal systems and controls have been set up to verify, as far as possible, that they are commissioned only when it is effective and efficient to do so and in a way that is as economical as possible. The internal processes aim to provide assurance that s166s are appropriately scoped to achieve their objectives; to give assurance that they are undertaken by those having relevant expertise; to monitor costs as the reviews are carried out; to provide feedback to Skilled Persons on whether their work has met expectations; and to identify any possible improvements to the overall s166 regime.

In particular:

- a) before a s166 review is commissioned, it needs to be approved by a senior member of the PRA, and a central Skilled Person team within the PRA provides challenge to, and quality assurance on, the commissioning decision;
- b) a Panel of Skilled Persons, comprising approved firms and individuals that have met specified technical and commercial criteria, is used by the PRA when it contracts directly. The Panel also provides a pool of expertise for regulated firms when they contract the Skilled Person; and
- c) at the end of the process, supervisors assess whether the s166 has met expectations in terms of quality, cost and timeliness. Feedback is provided to the Skilled Person who conducted the s166 and is taken into account when future selections are made from the Panel.

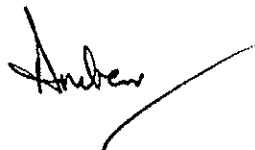
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Feedback and transparency on use of s166

Together with the FCA, the PRA regularly provides feedback on its experience with s166 reviews through presentations to all members of the Panel of Skilled Persons. It also aims to be as transparent as possible about the cost and frequency of s166 reviews by publishing quarterly and annual information on its website¹ and in its Annual Report respectively.

Yours Sincerely

A handwritten signature in black ink, appearing to read 'Andrew', with a long horizontal stroke extending to the right.

Andrew Bailey

¹ Quarterly reporting of numbers of s166s and categories can be found on our website at <http://www.bankofengland.co.uk/prs/Pages/supervision/activities/reportsskilledpersons.aspx>

Annex

A Skilled Person review (s166) is one of the regulatory tools the Prudential Regulation Authority (PRA) can employ under FSMA to obtain a view on aspects of a firm's activities, which may give rise to concerns or require further analysis.

The Skilled Person can be appointed either by the regulated firm – in which case the appointment must be approved by the PRA - or by the PRA directly. In both cases, the PRA has control over the scope of the s166 review, but the cost of the s166 is borne by the regulated firm in both cases.

Set out below are responses to each of the questions raised:

1. The cost and date of each skilled person review required by the PRA.

The use of s166 is part of our supervisory toolkit. We do not publish information about the supervision of individual firms because to do so might undermine the safety and soundness of a firm.

We have in the past considered the possibility of publishing details of the cost and date of each s166, but have concluded that, when taken together with information that is already in the public domain, it may reveal information about our supervision of individual firms. For that reason, we have provided below aggregate data on the number and cost of s166 reviews commissioned by the PRA in its first year of existence which we hope will provide a sense of the scale of use of the tool.

The figures in Box (i) below cover the 11 month period from the date of the PRA being established to the date of publication of its first Annual Report on 28 February 2014. We will provide you with the equivalent data for the three months to 31 May 2014 by 21 July.

To put these figures into perspective, Box (ii) sets out the number of prudential s166s commissioned by the Financial Services Authority in the previous year to end March 2013². It is worth noting that the cost per report in the eleven months to end February 2014 ranged from £14,602 to £1.3m. The equivalent range for the year to end March 2013 was from £33,795 to £3.0m.

Box (i)

PRA Skilled Person Reviews 2013/14 (11 month period from 1 st April 2013 to 28 th Feb 2014)				
Quarter	No. of reviews	Cost of reviews £mn	Lowest cost ³ £'000	Highest cost £'000
1	9	4.1	103	1,271
2	7	2.9	120	956
3	7	2.5	15	659
4	10	1.9	60	495
Total	33	11.4	-	-

Box (ii)

FSA Skilled Person Prudential s166 Reviews 2012/13		
	No. of reviews	Total Cost (£mn)
Total	27	14.7

² Source: 2012/13 Annual Report of the Financial Services Authority

³ The lowest and highest cost figures quoted were at time of reporting in the PRA Annual Report and represent either an actual cost incurred by the regulated firm or an estimate where actual costs were not available at time of reporting

2. What is the process by which the decision is taken to require a report by a Skilled Person under section 166 of the Act⁴?

The PRA's *Supervisory Statement, Reports by skilled persons - SS7/14* (Supervisory Statement) - explains when the PRA is likely to appoint a Skilled Person to produce a report for the PRA. It notes:

'The appointment of a skilled person to produce a report under section 166 FSMA is one of the PRA's regulatory tools. The tool may be used:

- i. for diagnostic purposes: to identify, assess and measure risks;*
- ii. for monitoring purposes: to track the development of identified risks, wherever these arise;*
- iii. for preventative action: to limit or reduce identified risks and so prevent them from crystallising or increasing; or*
- iv. for remedial action: to allow the PRA to respond to risks when they have crystallised.*

The use of the tool could be prompted by:

- i. a specific requirement by the PRA for information;*
- ii. an analysis of information undertaken by the PRA;*
- iii. an assessment of a situation by the PRA;*
- iv. expert advice or recommendations received by the PRA; or*
- v. a decision by the PRA to seek assurance in relation to a regulatory return.*

The tool may also be used as part of the supervisory programme applicable to a regulated firm, or the result of an event or development in relation to a firm, that is prompted by a need for verification of information provided to the PRA or part of the PRA's regular monitoring of a firm.'

In practical terms, this translates into the following approach:

When a supervisor identifies the need for regulatory action, an assessment is made to determine the appropriate supervisory tool to use. The assessment will consider:

- a) the regulatory tools available to address the risk identified. These may include a visit to the firm by the supervisory team; the use of the firm's Internal Audit function if it has the appropriate expertise and resources available to provide a sufficiently independent response to mitigate the risk that has arisen (see question 5 below); or the use of specialist PRA technical resources to conduct a review (see question 9 below). The conclusions reached will depend on the nature of the regulatory action needed and the particular circumstances involved. For example, the timescale for undertaking the work - i.e. whether it is necessary to take action quickly given the nature of the risk - will be relevant; and
- b) if it is thought that a s166 review is the appropriate tool, whether the estimated costs of a s166 review are proportionate to the regulatory risk being mitigated. This assessment will consider the potential benefits to be obtained by both the PRA and the firm from the review.

In undertaking this assessment, the supervisor is supported by a central Skilled Person function within the PRA that assists the supervisor in identifying the likely cost of the review, based on previous experience with any similar s166s.

3. At what level of seniority is approval given for the decision?

The approval is given at Head of Division level within the PRA, or above.

4. How do you decide whether the PRA will contract the Skilled Person or whether the regulated firm will do so?

As the ability for the PRA to contract directly is a new power, practice is still evolving. However, a number of factors are taken into account when deciding whether to contract directly with the Skilled Person or to require the regulated firm to do so. The main considerations are:

⁴ In this letter in our responses, we are referring to FSMA rather than the Act, though they are the same.

- a) the level of urgency to the review and whether it is believed that the PRA contracting directly would result in a more timely outcome;
- b) the need for control over the Skilled Person process, for example where the s166 review may lead to enforcement action or where the regulator is looking to commission a thematic review across a number of regulated firms and therefore needs to ensure consistency of approach;
- c) where we believe the firm may seek to exert undue influence over the Skilled Person, notwithstanding other controls around the s166 process which may provide us with assurance over the independence of the Skilled Person; and
- d) a need to be able to demonstrate independence during the Skilled Person process, e.g. where there is significant public or political scrutiny over the outcomes of a review.

5. Does the PRA utilise the Internal Audit Departments (IAD) of regulated firms for reviewing and assessing matters of potential concern? In firms with a strong independent IAD, please explain the reasons why that IAD would not be commissioned to perform such work in preference to third party firms.

The PRA often places considerable reliance on IADs and firms' other 'lines of defence', such as internal risk management and sound systems and controls, but there are occasions when the PRA requires the independent view and control that come with a s166 review which are not available from the use of a firm's IAD. Examples when use of a firm's IAD may not be appropriate include:

- a) the IAD may not possess the necessary expertise to undertake the work;
- b) the IAD may not have the capacity to undertake the work in the necessary timeframe; and
- c) the scope of the review may be such that it would be difficult for the PRA to be assured that the IAD would be sufficiently independent. For example, where the risk identified relates to the governance of the firm, use of IAD may not be appropriate given the potential conflict of interest with IAD's central role in a firm's governance function. Similarly, if the risk identified is in an area that the IAD function has recently reviewed, it might be inappropriate to commission the IAD to – in effect – review its own work.

6. What consideration does the PRA give to using other tools of regulation to mitigate potential risks, such as placing specific requirements on management and boards?

As set out in the PRA's documents on its approach to banking and insurance supervision, re-issued in June 2014, the PRA considers a wide range of factors and tools in order to mitigate risks. A key feature of the PRA's approach is a focus on the most material risks. Another is ensuring that there is a clear link between risks that the PRA perceives and the action it expects firms to take.

Within the context of these two important considerations, the PRA selects the most appropriate supervisory tools to mitigate a perceived or real risk. We certainly can (and do), as the question suggests, place specific requirements on the management and boards of firms. This may, for example, require formal board non-executive member attestations (e.g. on the effectiveness of a firm's functions), which would be undertaken as part of regular supervision. If, on the other hand, the PRA needs to impose requirements using formal powers, it can do so on the firm using its powers under Part 4A of FSMA (e.g. to prevent or curtail a firm undertaking certain regulated activities). When the Senior Management Regime enters into force, the PRA will also be able to make the approval of an individual senior manager subject to conditions, which could include a condition to carry out a particular action (e.g. to produce a business plan within a specified time). The PRA will be consulting in due course on the operation of the Senior Persons Regime and its approach to placing conditions on approval.

Supervision will typically work with a firm to prevent risks from crystallising or to remediate risks once they have transpired, for example by requiring the firm to address deficiencies identified over a set period or by setting additional reporting requirements. Indeed, the decision to use s166 often stems from the pursuit first of other supervisory activities at the PRA's disposal, such as 'close and continuous' work, supervisory risk assessment visits and monitoring of key ratios or analysis of regulatory returns.

The PRA's Supervisory Statement notes that the PRA's decision on whether to use the s166 tool will be tailored to the regulated firm, taking account of a wide range of features of the firm in question. These include the extent to which the firm is co-operating with the PRA; whether the firm has a history of similar issues; the quality of a firm's systems and records; the knowledge and expertise available to a firm; the PRA's assessment of whether the firm itself would be likely to produce an objective report on the issue; and whether there are conflicts of interest which mean that it would be inappropriate for the PRA to ask the firm itself to produce a report.

7. The PRA's policy on the use of Skilled Persons requires the regulator to have regard to the question of cost. What does this mean in practice?

Cost considerations and the question of proportionality are embedded within the s166 decision making process. As noted above, the PRA assesses whether there may be other supervisory tools it can use more effectively when deciding whether it is appropriate to commission a s166 review.

The PRA's Supervisory Statement notes that the PRA will be mindful of costs and lists relevant factors that it will take into account when considering costs. They include:

- i) *whether a firm may derive some benefit from the work carried out and recommendations made by the skilled person (e.g. a better understanding of its business and its risk profile, the operation of its information systems, or improvements to its systems and controls);*
- ii) *whether the work to be carried out by the skilled person is work that should otherwise reasonably have been carried out by a firm, or by persons instructed by a firm on its own initiative, for instance a compliance review or the development of new systems;*
- iii) *whether a firm's record keeping and management information systems are poor and:*
 - a) *the required information and documents are not readily available; or*
 - b) *an analysis of the required information cannot readily be performed without expert assistance;*
- iv) *the extent to which there appear to be risks that could threaten the safety and soundness of a firm or the protection of policyholders; and*
- v) *the perceived probability and seriousness of possible breaches of regulatory requirements and the possible need for further action.*

If it is decided that use of s166 is likely to be an appropriate and proportionate response, the scope of the s166 requirement is then drawn up to address the particular risks.

The subsequent steps on how the PRA has regard to the question of cost are noted in the response to the next question.

8. What steps do you take to ensure that the costs to firms are kept to a minimum?

To understand the steps we take to ensure that the costs are kept to a minimum, it is helpful to consider instances when the PRA appoints the Skilled Person directly; when the regulated firm appoints the Skilled Person; and other steps we take that have an impact on both approaches.

Appointing the Skilled Person directly

From 1 April 2013, the PRA and the FCA have had the power to appoint the Skilled Person directly. To enable the PRA and FCA to use this power in line with the European Procurement Directive and the Public Contracts Regulations 2006, a Panel of suitably chosen Skilled Persons was established⁵.

In assessing who would be on the Panel, we considered commercial as well as technical criteria and established agreed rates with each supplier.

⁵ For a list of suppliers on the Panel see

<http://www.bankofengland.co.uk/prasupervision/activities/skilledpersonpanel.pdf>

Where the PRA is contracting directly with the Skilled Person, and therefore using a supplier from the Panel, the PRA will factor price into its evaluation process and will assess the reasonableness of the proposed person's hours and charge-out rates against the agreed Panel rates, noting instances where a discount has been offered on the agreed rates. The PRA will also scrutinise the skill set of the proposed team with reference to the CVs in the proposal and the total proposed days by grade of staff. If the fees in a Skilled Person proposal significantly exceeded the PRA's expectations, the PRA would challenge, as part of the tender process, the Skilled Person on their understanding of the requirement notice and ask for the quote to be re-submitted. In a recent case, the PRA was able to negotiate the estimated costs of a s166 review down to what it considered a more proportionate use of the tool, and the Skilled Person agreed to cap its fees. This led to a 40% reduction in the cost.

Regulated firm appoints the Skilled Person

When the regulated firm is contracting directly with the Skilled Person, the PRA directs the firm to the Panel and instructs it to approach a number of potential Skilled Persons. However, it is then for the regulated firm to negotiate a competitive price for the work. In many cases, regulated firms will have their own 'Master Service Agreement' with Skilled Person firms on the Panel.

Once the regulated firm has selected its preferred supplier, it will provide the PRA with details of its nominated supplier's proposal, along with the details from other possible suppliers it has approached. The PRA will then assess the nominated supplier's proposal to see if it addresses the requirements of the s166 and whether the costs and allocation of Skilled Person resource are appropriate, among other key factors. If the estimated costs are significantly higher than the initial estimate when deciding to commission the s166, before approving the appointment, the PRA can ask the Skilled Person why that is the case e.g. whether the Skilled Person has correctly understood the scoping of the s166.

If we are aware of situations where a Skilled Person seems to be charging different rates for similar work to different regulated firms, we will discuss this with the Skilled Person. Also, if the Skilled Person's rates seem excessive, we inform the Skilled Person and note that we may take this into account when considering them for future work. The PRA would do this even where a regulated firm itself is contracting with the Skilled Person.

Other steps

For all s166 engagements, whether commissioned by the PRA or via the regulated firm, the Skilled Person is required to keep the PRA informed of any significant developments as and when they occur. This includes notification of any material changes (i.e. greater than 10%) in the estimated cost of executing the s166 report. This allows the PRA to re-assess the proportionality of the s166 review and engage in discussion with the Skilled Person as to the appropriateness of the cost increase. If there is cost creep due to expanding scope, the PRA will assess this against the need to perform work in areas that were not part of the original scope.

At completion of the s166, supervisors provide feedback to the Skilled Persons on whether the review has delivered against expectations in terms of quality, cost and timeliness. This feedback is also an input into the PRA's consideration of whether to use that Skilled Person in future appointments.

9. The minutes of the meeting of the Court of Directors of the Bank of England on 11 December 2013 record that "The PRA Board were certainly concerned, particularly about the ability of the PRA to undertake asset quality reviews. One approach was to commission more S166 reports outsourced to "skilled persons" to compensate". To what extent are these reviews used to compensate for a lack of expertise at the PRA?

The PRA has a strong Supervisory Risks Specialists division comprising experts in credit and traded risk, among others. Supervisory risk specialists support supervisors in conducting deep dives, including on-site file reviews. It is often the findings from such deep dives which lead to the decision to carry out further assessments via a third party review.

Nevertheless, there may be some situations in which the PRA does not have the appropriate skills in-house and/or may not have sufficient available resource in the timescale needed, e.g. expertise in IT infrastructure and data collection and storage. In such circumstances, and subject to the checks and balances already described, the PRA may decide to commission a s166 review to help it in its work.

10. To what extent is the use of s166 reviews helping to keep the costs of the PRA down?

The Skilled Person supervisory tool provides both the required resources and necessary expertise to review areas of concern identified within a firm and/or the effectiveness of remedial action a firm has taken.

At all times the PRA needs to consider the balance between maintaining skilled resource on its headcount as a fixed cost and using external experts, such as through the s166 mechanism.

When a number of s166 reviews are under way at the same time, the impact on the availability of internal resources would be significant if the PRA were to attempt to undertake the work in-house. This would also detract from day-to-day supervisory activities.

11. The Skilled Person provides both the required resources and necessary expertise to review areas of concern identified within a firm and/or the effectiveness or remedial action a firm has taken. It appears to be the case that the significant majority of s.166 commissions are awarded to the 'Big 4' accounting firms. What is the PRA doing to promote competition and encourage smaller, specialist firms to compete for s166 mandates?

We share your concern that a disproportionate amount of s166 work is undertaken by the 'Big 4' accounting firms. As noted above, a Panel of suitably chosen Skilled Person firms has been established since April 2013. As well as ensuring a consistent and high quality approach to conducting Skilled Person reviews, a key objective when we were setting up the Panel was to create more diversity in the firms that could be used for s166 work. There are approximately 15-20 Skilled Person firms on the Panel for each of the eight possible lots⁶.

When contracting directly with a Skilled Person, the PRA will use the Panel to tender the s166 review; equally where the firm has been directed to contract with a Skilled Person, the PRA will direct the firm to the Skilled Persons in the relevant lot(s) on the Panel (albeit the firm may choose to nominate a Skilled Person outside of the Panel, which possibly should further increase competition). In directing the firm to the Panel, this should assist the regulated firm in identifying expertise outside the 'Big 4'. We believe this should promote competition and diversity in the choice of Skilled Persons, but it will take time.

Of the 33 reviews commissioned in the 11 month period from the date of the PRA being established on 1 April 2013 to its year-end at 28 February 2014, 23 reviews were undertaken by 'Big 4' accounting firms. While this indicates a concentration within the Big 4, the PRA does not favour any Skilled Person firm and follows a transparent and consistent approach to selecting or approving Skilled Persons, ensuring that the tender process is competitive and objective.

Where the regulated firm is contracting with a Skilled Person and has nominated a Skilled Person, the PRA will approve the firm's appointment, taking into account the competence, capability and independence of the Skilled Person. Where the PRA is contracting directly with a Skilled Person, it will have greater control over the evaluation process, but the decision on whom to award the contract is ultimately based on the most compelling tender, having regard to quality and technical criteria as well as price. Of the nine s166 reviews contracted directly by the PRA since it was established to 31 May 2014, a non-Big 4 accounting firm was selected in five of those cases.

12. On both a case by case basis and in aggregate, how does the PRA judge the value for money from s.166 reviews?

Value for money is, of course, a matter both of cost and of the contribution a s166 review makes to prudential regulation.

A key factor in supporting value for money overall is that the PRA operates within a risk-based framework in which the intensity of a firm's supervision depends on the risks it poses to the PRA's objectives. For all regulated firms, supervisory attention is sharply focused on major issues.

⁶ For a description of each category refer to <http://www.bankofengland.co.uk/prs/Documents/supervision/activities/skilledpersonpanellotdescriptions.pdf>

On a case by case basis, the PRA reviews the lessons learned from a s166 once it is completed and considers, inter alia, whether it has met supervisory expectations and whether the costs were in line with those originally estimated. Cost control is crucial in ensuring value for money. As highlighted earlier, the PRA assesses the likely cost when deciding to commission a s166 review, taking into account actual costs of previous and similar s166 reviews. In situations where the PRA appoints the Skilled Person, the process of using the Panel, and having a tendering process where both technical expertise and the cost of the s166 are assessed, helps to achieve the lowest price for engagement.

13. To what extent does the PRA coordinate with the FCA in the scoping of s166 reviews in order to manage costs and efficiency?

The PRA works closely with the FCA in the co-ordination of its s166 processes. When deciding to commission a s166 review, PRA supervision will identify those areas which may be of relevance to the FCA (and vice versa) and will work jointly in drafting the scope where this is considered pertinent. The FCA and the PRA are currently working together on scoping a joint s166 review.

14. Will you publish the costs of reviews in which the PRA appoints the Skilled Person separately from those of cases in which the firm makes the appointment?

The PRA has not previously published the aggregate costs of s166 reviews in its Annual Report in the form the question describes, but we are happy to commit to doing so in the future.

The power to commission s166 reviews directly was only introduced in April 2013 and was only used in nine instances in the 14 month period to 31 May 2014. The cost of the four s166 reviews which the PRA contracted directly in 2013/14 came to £0.8m, out of a total cost of £11.4m for all s166 reviews commissioned in that period.

15. What oversight does the Board have of the use of s166 reviews?

The PRA Board receives a quarterly report that contains statistics on the use of the s166 tool.