FCA response to the recommendations/observations made by the Treasury Committee

Para. 50: The regulators need to explain to the Treasury Committee what steps can be taken to ensure reviews of major bank failures can be run, at least in part, alongside enforcement investigations

The issue of concurrent inquiries (i.e. a parallel major bank failure review and an enforcement investigation) needs to be judged on a case by case basis; it is akin to the court's discretion to stay civil proceedings pending criminal proceedings, and will vary from case to case. However, the investigative work for, and publication of any report following a major bank failure review, before an enforcement investigation is concluded, carry considerable risk, chiefly:

- *the potential prejudice to disciplinary proceedings if the report was published before their conclusion; and*
- *the potential unfairness to a firm or individual under enforcement investigation by the regulator, that may arise as a consequence of their contemporaneous involvement in a bank failure review.*

It may be possible to run a parallel review at least in part, as the recommendation suggests, if a distinction is made between carrying out work on the review and its publication but an assessment would need to be made in each particular case whether this is possible. For example, it may be possible to work on matters such as the initial identification, gathering and review of relevant documents, even if the investigation is still on-going, which has been done in previous reviews. Inevitably, the risks will be far more acute in respect of more substantive investigative steps, for example, the conduct of interviews that will touch on issues relevant to the enforcement investigation and the bank failure review. In those instances where it is possible to commence a parallel review, the issue of the timing of interviews and external requests for information and evidence would need to be carefully managed, in part to mitigate the potential unfairness to the subject under investigation. It may be that any concurrent work on a review will need to be paused so as to avoid an adverse impact on the evidence likely to be obtained in either the enforcement investigation or the review, in cases where an individual's ability to explain themselves or address potential allegations in the enforcement investigation is unfairly constrained by concurrent inquiries. In circumstances where a pause might be required, it may be necessary to consider whether, given the costs and practical implications of a significant pause, it would be preferable not to begin the review until the conclusion of the enforcement proceedings.

The extent of any likely overlap between the scope of an enforcement investigation and that of a parallel bank failure review will be a significant factor in influencing whether it is appropriate and practicable to progress those inquiries in parallel. For example, an enforcement investigation might include consideration of whether a senior manager at the bank failed to apprise the regulator of information relevant to the bank's financial position. A review of the regulatory response in relation to the failed bank might also need to consider whether that same information was provided to the regulator, to determine whether the regulatory strategy was appropriate, given the information available. In those circumstances, where both inquiries would turn on the same issue, the senior manager may well be cautious as to the extent of *their co-operation with the parallel review of the bank failure. Concern about the risk of prejudice to their position in respect of the enforcement investigation may well colour the senior manager's decision on whether to provide an account, or documents within their possession, to the bank failure review.*[1] *Challenges that the regulators may face in conducting parallel inquiries are not limited to any balance that needs to be struck between an enforcement investigation and a regulatory review. Section 78 of the Financial Services Act 2012 provides that:*

"(2) In carrying out such an investigation [a regulatory failure review], the regulator must have regard to the desirability of minimising any adverse effect that the carrying out of the investigation may have on the exercise by the regulator of any of its other functions.

(3) The regulator may postpone the start of, or suspend, an investigation if it considers it necessary to do so to avoid a material adverse effect on the exercise by it of any of its other functions."

There may, therefore, be circumstances where the events giving rise to any regulatory review mean that the regulators also need to consider the impact of carrying out such a review on the need to exercise its other functions in, for example, prudential or supervisory matters and which could mean postponing or suspending a review.

Para. 62: Inquiries into major bank failures should be conducted independently of the regulators.

We agree with the recommendation.

Para.86: The policy of naming FCA employees below the level of Director should be flexible. Those leading the review should have the freedom to determine if the public interest would best be served by naming particular employees.

Senior management are those responsible for setting the strategy of the organisation, and should be held accountable for the consequences. That is one of the principles that underpin the SMCR, which the FCA applies to itself, allowing for the different functions and responsibilities of the FCA, as against those of regulated firms. We consider it entirely consistent with our application of the SMCR that the naming of FCA employees in the course of such a review should be restricted to Directors, who have formally accepted their accountability for regulatory strategy and outcomes through their Statements of Responsibilities.

For these reasons, we do not agree with the recommendation for a flexible policy, the introduction of which might militate against the exercise of judgment based decision-making by staff below Director level, who are charged with the administration and execution of the strategy set by their senior management.

In addition, it is not apparent that the public interest would be served by naming employees below the level of Director, in the context of a review into a major bank failure.

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[1] *Stuart Bernau and Iain Cornish, specialist advisers to the Treasury Committee in relation to the FCA/PRA review into the failure of the HBOS group, stated that they found interviews with most (but not all) former HBOS staff were much less helpful because of the guarded and defensive tone adopted by interviewees (who were not under investigation). Given Andrew Green QC's recommendation that even if an individual is not under investigation at the outset, this is a matter that should be regularly reviewed, the experience of the HBOS Review suggests that it is not only subjects under investigation who will likely give limited and less helpful responses, but this will extend to individuals who are not under investigation at the time any parallel review is underway, but are concerned that they may be investigated at a later date.*

Para. 95: Regulators should review their conflict of interest policies for appointments to their Boards. Conflict of interest policies must not be allowed to exclude access to much needed industry expertise but should be seen as a set of robust procedures. The Treasury Committee will seek assurances that such procedures are in place.

We recently reviewed our conflict of interest policy for Board members, and the policy, approved by the FCA Board, will be published in the week commencing 10 October. In the course of revising that policy, we have had regard to the TSC's recommendation for 'robust procedures' which do not 'exclude access to much needed industry expertise'. We believe that the revised policy will achieve these objectives.

The issues identified by the TSC are specifically addressed at paragraph 21 of the policy, the content of which is as follows:

'Persons considered for appointment as an appointed member of the FCA Board are expected to have extensive relevant experience for the role. Consequently, such individuals may hold, or have recently held, executive or non-executive directorships or partnerships at other organisations, including FCA-authorised firms. However, the existence of such a relationship with the larger authorised firms would disqualify an individual from appointment to the FCA Board. The panel responsible for recommending appointable candidates to Ministers makes a judgement on a case by case basis whether the size, significance and nature of the firm's business, and the individual's role within it, in the context of the FCA's objectives is such as to require disqualification.'

Para. 115: Detailed rules are no substitute for high-quality supervision – the regulators should rely less on bureaucratic processes and instead demonstrate that they can exercise more balanced judgment across a complex financial system.

Judgement is at the heart of the new approach to Supervision adopted since 2013. This is done against a framework of rules. We will shortly consult on a draft Mission statement that will support us in refining our regulatory focus, and promote public understanding of how we make choices within our remit. When finalised in 2017, our Mission will support us in being focused and transparent about our operational priorities, including our approach to supervising firms.

Para. 120: The Treasury Committee expects regulators if they feel political pressure to inform Parliament, it is a duty.

Parliamentary scrutiny is a vital part of maintaining independence, and if the FCA feels it is being pressured we will of course inform the Treasury Select Committee.

Para. 122: The Treasury Committee expects the regulators to use the new SMCR and the "twin peaks" system powers and to demonstrate independence in their use.

The foremost purpose of the financial regulation architecture is to maintain a stable institutional structure: the twin peaks system. As one side of the system, the FCA regulates the conduct of more than 56,000 businesses. We are also the prudential regulator for over 24,000 of these firms. The Prudential Regulation Authority, on the other hand, is the prudential regulator of banks, building societies, credit unions, insurers and designated investment firms.

We are an independent public body funded entirely by the firms that we regulate. Our work and purpose is defined by the Financial Services and Markets Act 2000 and we are accountable *to Parliament. We work independently of but collaboratively with the PRA to achieve our statutory objectives.*

The SMCR, introduced in March earlier this year, supports the respective aims of the regulators to achieve effective conduct and prudential supervision. It is important that all firms, regardless of size, are well-governed, with accountable senior managers and a culture that promotes their safety and soundness and the interests of their customers. The FCA and PRA are applying these regimes to firms in a proportionate manner, bearing in mind the differing size and complexity of firms in scope. More detail on the purpose of the SMCR is provided in our response to paragraph 136.

Para. 136: It is hoped that the new SMCR will enhance the credibility and fairness of enforcement in future, given that they should lead to much clearer lines of individual responsibility. If the regulators find in future that these changes are not enough to establish a credible enforcement regime, they should say so.

The SMCR is central to improving standards of individual accountability and restoring trust in the financial sector. Individuals, their employers and regulators need to know who is responsible for what. When things go wrong this new regime should ensure that the right people are held to account.

The SMCR is also supported by a new set of individual Conduct Rules which set basic standards of good individual conduct for all staff. This sends a powerful message to all employees in banks that good conduct is their personal responsibility, helping to foster a culture of accountability throughout the sector.

The SMCR is an absolutely fundamental reform. We have recently published feedback on initial implementation, including on the allocation of Senior Management Functions and responsibilities. We will continue to monitor the impact of the regime and if we receive evidence that SMCR is not fulfilling our expectations, we will, of course, relay our concerns back to the Treasury Select Committee.

Para.160: It is far from satisfactory that the bulk of enforcement staff and expertise still lies within the FCA in relation to prudential failings in which it has no supervisory role. An independent enforcement function should sit equidistant between the PRA and FCA.

This assertion is incorrect as the FCA does not constrain choices made by the PRA on the appropriate level of enforcement resources.

Para.163: The Committee concludes that the case for structural separation has merit. The Treasury Committee expects the Treasury to appoint an independent reviewer to re-examine the case for a separate enforcement body.

The FCA has a broad range of tools at its disposal to enable it to carry out its objectives. Enforcement, the role of which is to investigate the facts and establish whether breaches of FCA rules have occurred, is an essential part of that toolkit. Removing Enforcement from the FCA would denude the FCA of its ability to investigate breaches of its own rules, and threaten our ability to be an effective regulator.

Most Enforcement investigations concern issues identified by Supervision and Market Oversight. Extensive liaison between those functions takes place before, during and after a decision is formally taken to begin an Enforcement investigation. That co-ordination, decision-making and insight on issues central to ongoing Enforcement investigations, on which Andrew

Green QC placed great importance in his HBOS Review recommendations, would be seriously jeopardised by institutional separation.

Many of the misconduct issues that the FCA needs to address have a number of strands that are often best resolved through a package of measures. Issues that arise will often need to be dealt with urgently. In the financial year 2015/16, Supervision and Enforcement worked together to complete 17 early interventions to eliminate or reduce ongoing risks to consumers or markets. In some of those cases, the FCA will have reached a voluntary agreement with the firm without using our formal statutory powers and without the need for formal disciplinary action. Other issues may span across a sector or number of firms. In those cases we may wish to use a combination of tools – from education to intervention as well as our formal civil, criminal and regulatory powers.

The firms we regulate are acutely aware of the cost of regulation. A separate enforcement body would leave the FCA unable to take disciplinary action to directly enforce its own rules, while at the same time, a self-standing enforcement body would need separate funding, resourcing and the ability to detect its own work and govern itself, increasing the overall costs of regulation.