

**PRA response to the recommendations made by the Treasury Select Committee -
Review of the reports into the failure of HBOS plc**

The Prudential Regulation Authority (the “PRA”) welcomes the opportunity to respond to the recommendations made by the Treasury Select Committee in its Review of the reports into the failure of HBOS plc dated July 2016.

The PRA responds to the recommendations which refer to its role and statutory objectives. In this response, the Treasury Select Committee’s recommendation is replicated in bold at the beginning of each section, followed by the PRA’s response to that recommendation.

Conducting future reviews alongside enforcement action

Para 50. It is likely that a future bank failure would result in subsequent enforcement action, which may be a lengthy and complex process. It is unacceptable, however, that the public should have to wait so long for an explanation of what went wrong in cases of major bank failure. In the light of legislative changes since HBOS’s collapse, the Treasury and the regulators need to explain to the Treasury Committee what steps they can take to ensure that reviews of this type - which in future will be led by independent persons - can be run, at least in part, alongside enforcement investigations. An arrangement where the public must wait several years for a review even to start would be wholly unsatisfactory.

As the Treasury Select Committee noted, there have been key legislative changes since HBOS’s collapse. Part 5 of the Financial Services Act 2012 (FSA 12) makes provision for inquiries and investigations which can be initiated by the Treasury and by a number of regulators including the PRA and the FCA (“Part 5 reviews”). Part 5 reviews may be commenced, for example, where there may have been possible regulatory failure or the Treasury considers it is in the public interest that a regulator should investigate relevant events. The PRA has therefore consulted the FCA and the Treasury on its response.

The PRA acknowledges the public interest in Part 5 reviews, specifically into major bank failure, taking place as quickly as possible. The PRA also acknowledges the concerns, highlighted at para 47, of independent reviewers that the long delays in starting the report can lead to a deterioration in the available evidence. However this needs to be balanced against the public interest in ensuring that the PRA can achieve effective enforcement outcomes.

The PRA agrees that Part 5 reviews should report in a timely way, and that consideration must be given to the risks of running Part 5 reviews in parallel to enforcement investigations. The PRA takes a case by case approach to considering whether a Part 5 review could begin, at least in part, alongside enforcement investigations.

It is clear that concurrent enforcement investigative work and publication of reports of Part 5 reviews may pose considerable risks.

- 1) Carrying out interviews in a Part 5 review while an enforcement investigation is on-going risks tainting subsequent evidence obtained in the enforcement process. Firms or individuals may provide information in the Part 5 review which may directly affect the quality or credibility of evidence obtained in the enforcement investigation. This may only become apparent on publication of the Part 5 review and/or outcome of the enforcement investigation.

- 2) There may be potential prejudice to an enforcement investigation if the report of the Part 5 review was published before the conclusion of the enforcement investigation. An enforcement investigation may have focused on specific issues or provision of information which are addressed in detail in the Part 5 review. Also, firms and individuals have rights of reply in enforcement investigations which may be undermined by the publication of the findings of the Part 5 review.
- 3) Concurrent investigation gives rise to potential unfairness to a firm or individual to have to deal with interviews and requests for information in respect to a Part 5 review at the same time as dealing with an enforcement investigation. This can be from a practical and costs perspective. The consequences of a Part 5 review and enforcement investigations are very different for firms and individuals and accordingly, dependent on the focus, cooperation will be prioritised accordingly to reflect this by the relevant firms and individuals.

However, depending on the subject matter and scope of the enforcement investigation and the relevant Part 5 review, it may be possible to commence and conduct earlier stages of Part 5 review without some or all of these risks arising. Such preliminary work could include planning, collation and initial review of documents, and production of a timeline for next steps in the review into major bank failure. The PRA's policy that Part 5 reviews should normally be carried out by a person independent of the regulator should assist that process, in that in most cases the preparatory work will not be being done within the PRA's premises, or by PRA staff .

However, there would still be a necessary pause in any Part 5 review before proceeding to those later stages which could be prejudicial to an enforcement investigation. In many cases, there is likely to be considerable uncertainty about the time an enforcement investigation could take to complete and therefore the length of such a pause in the Part 5 review. In each case, consideration would need to be given to the impact on the cost and effectiveness of the part running of a Part 5 review in parallel to an enforcement investigation, including in relation to the PRA's ability to appoint and retain an independent person to lead or work on a review of major bank failure, and the potential benefits that might arise in terms of more timely reporting.

The PRA also notes that potential overlap with an enforcement investigation is just one of the factors which have a bearing on the timing of a Part 5 review. Other factors might include, for example, the impact of the Part 5 review on the supervision of the firm concerned.

The FSA 12 recognises those challenges, and the following provisions of s.78 FSA 12 are particularly pertinent in respect of Part 5 reviews:

“(2) In carrying out such an investigation, 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.”

Independence of regulatory reviews

Para 62. Both the regulators and the independent reviewers supported the view that future inquiries into major bank failures should best be conducted wholly independently of the regulators. The Committee agrees. The Government has already partially addressed this in the provisions contained in the Financial Services Act 2012. In theory, the Act goes some way towards providing what is needed. In practice, the legislation remains defective. It is far from satisfactory that the Treasury retains the authority to prevent an inquiry under the Act, even when both the regulators and the Committee may have concluded that one is necessary. There may be a case for a Treasury override in the national interest in exceptional circumstances, accompanied by an obligation to report to the House. However, the current legislation has gone too far. The Treasury has arrogated to itself full control over the scope and continuation of any inquiry. The case for an amendment to the Act, overriding this blocking power, is therefore strong.

The PRA continues to be of the view that future inquiries into major bank failures should best be conducted independently of the regulators. This is reflected in the PRA's Policy Statement of April 2013 "Conducting statutory investigations"¹ which states:

"Once a serious regulatory failure is judged to have occurred, an investigation will be initiated as soon as possible...The PRA will normally engage independent, external specialists in connection with its investigations.....a range of measures tailored to the circumstances of the matter will be employed in investigations, including: desk-based analysis of documents; interviews of PRA staff; interviews with the relevant firm or other external parties; and the use of expert analysis or opinion. The PRA will also co-ordinate with other parties as appropriate, including the FCA. The PRA will inform the FCA of aspects of the investigation relevant to it, and will seek its input where necessary."

Naming employees in regulatory reviews

Para 86. The policy of naming individuals should be flexible. In most cases it may be appropriate to offer anonymity to employees below the level of Director. There should, however, be scope for exceptions. In future, those leading a review should have the freedom to determine if the public interest would be best served by naming particular employees.

The PRA is of the view that those individuals who held positions in senior management at Director level or above at the relevant time – that is, those who may have been responsible for setting the direction, strategy and policies of the PRA - should be held accountable for the consequences.

This is consistent with the approach taken in the HBOS² and RBS Reviews³. The Bank of England applies the Senior Managers Regime to its own staff and the PRA considers it consistent with that policy that the naming of employees should be restricted to Director level or above.

¹ <http://www.bankofengland.co.uk/publications/Documents/other/pr/conductstatinvestigations.pdf>

² By which we mean the FCA and the PRA's Report on the failure of HBOS plc dated November 2015. <http://www.bankofengland.co.uk/pr/Documents/publications/reports/hbos.pdf>

³ By which we mean the Financial Services Authority Board Report on the failure of the Royal Bank of Scotland dated December 2011. <http://www.fsa.gov.uk/pubs/other/rbs.pdf>

As a result, the PRA does not fully support the recommendation for a flexible policy on naming of staff, which in relation to staff below Director level who are charged with executing the strategy set by senior management, would be likely to have the effect of undermining their ability to carry out the forward looking, judgement-based supervisory work that is at the heart of the PRA's supervisory approach.

In addition, it is not clear how a review naming junior members of staff who operate within the frameworks devised and set by senior management could be said to be necessary in the public interest.

Board-level conflicts of interest policies in the PRA

Para 95. It is right that the regulators should review their conflict of interest policies for appointments to their Boards. The Treasury Committee has repeatedly identified this as a crucial issue for regulatory governance. Conflict of interest policies must not be allowed to exclude access by regulators to much needed industry expertise. But regulators also need to have, and to be seen to have, a set of robust procedures for dealing with a conflict of interest when it does arise.

The PRA's most important decisions are taken by its Board. The PRA has always recognised the importance of a clear and robust conflicts policy at board level and has maintained such a policy⁴ (the "Policy") since 2013, when the PRA came into existence. Close scrutiny is applied to the financial interests, directorships and employment and consultancy arrangements of members of the PRA Board.

The Policy stipulates that members of the PRA Board should have the necessary expertise and experience to command respect in the UK and abroad. Its purpose is to avoid the potential reputational damage that would stem from any perception that members were insufficiently qualified. This requirement for breadth of industry experience is clearly reflected in the current PRA Board.

Further, the Bank of England and Financial Services Act 2016 will require the Bank of England to issue and maintain a code of practice describing how members of the Prudential Regulation Committee (the "PRC") are to comply with provisions relating to conflicts of interest. To meet that requirement, the Court of the Bank of England approved a conflicts of interest code of practice ("the Code") on 28 April 2016. The Bank of England proposes to publish the Code when the PRC comes into being.

The principal purpose of the Code is to set out principles, guidelines and robust procedures for identifying, monitoring and managing actual or potential conflicts of interest with a view to ensuring the independence, integrity and impartiality of the PRC's decision-making in the performance of its functions. The Code's purpose is also to avoid any perception that a committee member or any connected person may obtain an unfair advantage by reason of the committee member's association with the PRC (for example, by assumed access to information or policy thinking).

The requirement for industry expertise is acknowledged as the Code sets out independent members who sit on a part-time basis are appointed on the basis of having knowledge or experience which is likely to be relevant to the PRC's functions.

⁴ By which we mean the Policy on conflicts of interest of the "appointed members" of the PRA Board dated September 2013. <http://www.bankofengland.co.uk/pradocuments/about/praconflicts.pdf>

Importance of judgement-based supervision

Para 115. The case of HBOS demonstrates that detailed rules are no substitute for high-quality supervision. The challenge now for regulators is to rely less on bureaucratic processes and instead to demonstrate that they can exercise more balanced judgement across a complex financial system. This is no easy task.

The PRA recognises the importance of, and is committed to delivering, high-quality, proportionate and balanced supervision. Since its inception the PRA has focused on strengthening the UK financial system through the adoption of a forward-looking and judgement-based supervisory model, proactively taking action to advance its statutory objectives.

As set out in the response to Para 86, the Bank of England applies the Senior Managers Regime to its own staff. In line with the core principles of the Senior Managers Regime, the PRA has completed a Responsibilities Map and Statements of Responsibilities for executive Senior Managers. The Chief Executive Officer (CEO) of the PRA has responsibility for delivering the PRA's strategy; day-to-day management of the PRA in accordance with the statutory objectives, the PRA's Approach to Banking and Insurance supervision, and the expenditure of the PRA levy.

The PRA has published two documents setting out its approach to Banking⁵ and Insurance⁶ supervision, which explain how the PRA's approach works in practice.

Supervisors reach judgements on the risks firms pose to the PRA's objectives based on a careful analysis of relevant evidence and they consider how such risks may be mitigated at the earliest stage possible. They are forward-looking, assessing firms not just against current risks but also against those that could plausibly arise in the future.

The PRA's approach relies on the judgement of skilled and experienced supervisors, and with due escalation to senior staff in the PRA for the most significant decisions.

Independence of the PRA

Para 120. The regulators have repeatedly asserted that they operated in an environment which encouraged 'light touch' regulation. This point may have merit but it does little to justify the severe flaws in the supervision of HBOS. In its report on RBS, the Treasury Committee in the last Parliament correctly identified that the FSA was given statutory independence to enable it to resist political pressure. The FSA's past recourse to political encouragement to promote 'light touch' regulation does not inspire confidence in the new regulators' capacity to demonstrate the independence required by their statutory mandates. In future, if the regulators do feel under such pressure, it is their duty to inform Parliament. The Treasury Committee will expect them to do so.

The PRA notes the comments made by the Treasury Select Committee.

Para 122. The financial crisis exposed major shortcomings in the existing approach to financial regulation.... The regulators now have a better set of tools at their disposal. The Treasury Committee expects the regulators to demonstrate independence in their use.

⁵ <http://www.bankofengland.co.uk/publications/Documents/praproach/bankingappr1603.pdf>

⁶ <http://www.bankofengland.co.uk/publications/Documents/praproach/insuranceappr1603.pdf>

The PRA notes the comments made by the Treasury Select Committee.

On 7 March 2016, the PRA implemented the Senior Managers and Certification Regime (SMCR) which will clarify the lines of responsibility at the top of regulated firms, enhance the regulators' ability to hold senior individuals to account and require regulated firms to regularly vet their senior managers for fitness and propriety. The PRA continues to work closely with the FCA to implement the SMCR.

The PRA will ensure it retains independence in the exercise of the suite of supervisory and regulatory tools available to it to regulate firms and individuals efficiently and effectively.

Para 123. Both the new powers gained by regulators and their poor performance prior to the crisis increases the need to ensure that regulators are challenged and required to explain their actions and decisions. This is primarily a duty for Parliament in general, and the Treasury Committee in particular. The new accountability arrangements - including new powers for the Treasury Committee over the appointment of the Chief Executive of the FCA - are an improvement. But it is not yet clear that the current framework is satisfactory. The Treasury Committee will need to consider this issue further in the light of the changes made by the Bank of England and Financial Services Act 2016.

The PRA notes the comments made by the Treasury Select Committee.

Para 136. It is to be hoped that the Senior Managers and Certification Regimes 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.

As the Treasury Select Committee notes at para 121, the SMCR is a central element of the post financial crisis agenda and will hold individuals working at all levels within relevant firms to appropriate standards of conduct and ensure that senior managers are held to account for misconduct that falls within their area of responsibility.

At the heart of the new accountability regime is the principle that an individual can delegate tasks but cannot delegate responsibility. This means that senior managers at banks and insurers should know what they are responsible for and can be held accountable for failings in their area of responsibility. This is a crucial step forward in the PRA's drive for greater individual accountability in the financial services industry and is a valuable enhancement to its enforcement regime.

The PRA will continue to monitor the SMCR closely to ensure that outcomes are consistent with our objectives.

Recommendation relating to Enforcement

Paras 160-163: First, the Committee notes that the collapse of HBOS, along with other UK financial institutions during the crisis, was the result of prudential failings. It is far from satisfactory that the bulk of enforcement staff and expertise still lies within the FCA, which has no role in prudential supervision of banks. An independent enforcement function could and should sit equidistant between the PRA and FCA.

The PRA's approach aims to resolve risks to the PRA's objectives before they crystallise, but the PRA also uses enforcement to advance its objectives. Use of enforcement powers can achieve this by changing, and promoting high standards of behaviour amongst firms; sending a clear signal to a firm and individuals, and to the regulated community more widely, about the circumstances in which the PRA considers a firm's or an individual's behaviour to be unacceptable; and deterring future misconduct.

The Regulatory Action Division (RAD) in the Bank of England's Legal Directorate is responsible for carrying out enforcement investigations for the PRA. This is a dedicated Division made up of staff with considerable enforcement and investigative skills and expertise. It has established a good track record of enforcement outcomes addressing prudential failings. It has achieved these outcomes not only through its own investigation teams but also, in appropriate cases, by carrying out joint investigations with, and outsourcing the investigations to, the FCA. The PRA and the FCA co-ordinate closely on enforcement issues, and the PRA considers that those arrangements, which are closely monitored by both regulators, work effectively.

The PRA has made clear in its Approach Documents that, as a prudential regulator it is focused on ex-ante intervention to prevent risks from crystallising. By their nature prudential enforcement cases arise less regularly than conduct cases, so while the PRA carries out less enforcement activity than the FCA, it also has a suite of enforcement tools that it has deployed – and will continue to deploy - as the circumstances warrant it. However, RAD, which came into existence on 1 April 2013, has consistently delivered a number of impactful enforcement actions since that date, including:

- levying a financial penalty on 19 November 2014 on Royal Bank of Scotland, Natwest Bank and Ulster Bank for IT failings⁷;
- imposing a public censure on 11 August 2015 on the Co-operative Bank Plc⁸ and on 14 January 2016 fining and prohibiting Barry Tootell⁹ (former CEO) and Keith Alderson¹⁰ (former MD of Corporate and Business Banking);
- levying a fine on 12 November 2015 on R. Raphaels & Sons Plc¹¹ for failures in its outsourcing arrangements; and
- levying a fine on 1 February 2016 on Millburn Insurance Company Limited¹², and fining and prohibiting Colin McIntosh¹³ (the CEO of Millburn).

The PRA's experience is that supervisory remediation and enforcement activity often arise out of the same set of circumstances, and as a result RAD also provides timely support to

⁷ <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en201114.pdf>

⁸ <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en110815.pdf>

⁹ <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en150116a.pdf>

¹⁰ <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en150116b.pdf>

¹¹ <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en271115.pdf>

¹² <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en010216.pdf>

¹³ <http://www.bankofengland.co.uk/pradocuments/supervision/enforcementnotices/en010216a.pdf>

supervisors in dealing with issues they may need to resolve using the PRA's supervisory powers. As such, the PRA recognises and is committed to on-going and close co-operation between RAD and Supervision which is key not only to ensuring appropriate consideration of whether a matter ought to be referred for investigation, but also to the question of what appropriate supervisory remedial action may be taken.

The PRA believes that Andrew Green QC supported a close working relationship of that nature in recommending increased co-operation between enforcement and supervision in his review of the FSA's enforcement decisions relating to HBOS¹⁴.

Establishing a separate enforcement regulator, equidistant between the PRA and the FCA, would break that valuable, effective link and would have considerable disadvantages. In the PRA's view, such a reform would run a real risk of making it more difficult for the PRA to achieve effective and efficient regulatory outcomes across the spectrum of supervision and enforcement.

The PRA notes that the FCA has also raised the question of how such a separate body would be funded, resourced, and importantly how it would detect its own work and govern itself. The PRA believes that these are significant issues that would have a direct impact on the effectiveness of any such arrangement.

¹⁴ <http://www.bankofengland.co.uk/pradocuments/publications/reports/agreenreport.pdf>