

Policy Statement

Conducting statutory investigations

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BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



Introduction

1. The Prudential Regulation Authority (PRA) is required, under the Financial Services Act 2012 (the Act), to investigate and report to HM Treasury on possible regulatory failure and matters of public interest.

2. This statement fulfils the requirement, under section 80 of the Act, for the PRA to describe how it will discharge its functions in carrying out investigations and for identifying where regulatory failure has occurred. It has been approved for publication by the PRA and HM Treasury.

Statutory provisions

The PRA's objectives

3. The PRA has two statutory objectives:

- to promote the safety and soundness of PRA-*authorised firms*,⁽¹⁾ primarily by seeking to minimise the adverse effect their failure could have on the stability of the UK financial system, and by seeking to ensure that they carry on their business in a way that avoids any adverse effect on the stability of the UK financial system; and
- for insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.

4. Consistent with those objectives, it is not the PRA's role to ensure that no PRA-*authorised firm* fails, as made clear in section 2G of the Financial Services and Markets Act 2000 (FSMA).⁽²⁾

5. As described in the PRA's policy documents on its approach to prudential supervision,⁽³⁾ the PRA's supervision will be driven by its statutory objectives. The objectives will also act as guiding principles for the PRA in identifying regulatory failure.

The PRA's duty to undertake statutory investigations

6. There are three broad circumstances in which the PRA is required under the Act to conduct a statutory investigation:

- (i) where it appears to the PRA that a serious regulatory failure has occurred; or
- (ii) where it appears to HM Treasury that a serious regulatory failure has occurred; or
- (iii) where HM Treasury considers an investigation to be in the public interest.

7. As required by the Act, this paper sets out how the PRA will identify whether the conditions for an investigation into regulatory failure are met, and how it will carry out

investigations both into regulatory failure and matters of public interest.

Identifying regulatory failure

8. Reflecting the PRA's statutory objectives, the Act sets out three conditions which trigger the requirement for an investigation into regulatory failure by the PRA:⁽⁴⁾

- (a) **Public expenditure** — where **relevant public expenditure** has been incurred in respect of a PRA-*authorised firm* and might not have been incurred but for a **serious failure in the scope or design of the system of regulation or the operation of that system**; or
- (b) **Safety or soundness** — where events have occurred which had, or could have had, a **significant adverse effect on the safety or soundness of one or more PRA-*authorised firms***, which might not have occurred, or the effect of which might have been reduced, but for a **serious failure in the scope or design of the system of regulation or the operation of that system**; or
- (c) **Policyholder protection** — where events have occurred, relating to the effecting and carrying out of contracts of insurance by a PRA-*authorised firm*, which indicate a **significant failure to secure an appropriate degree of protection for policyholders**, which might not have occurred, or the effect of which might have been reduced, but for a **serious failure in the scope or design of the system of regulation or the operation of that system**.

9. Should it appear to the PRA that any of these three conditions have been met, the PRA will be required to investigate the events in question and the circumstances surrounding them. The PRA must report to HM Treasury on its findings and, subject to some restrictions as described below, this report must be published.

10. An investigation into regulatory failure may also be required in connection with the Lloyd's insurance market, in which case the requirements will be the same as the above save that they will refer respectively to:

- (a) relevant public expenditure that has been incurred in respect of a member of the Society of Lloyd's;

(1) 'PRA-*authorised firms*' refers to all firms prudentially regulated by the PRA, namely deposit-takers, insurers and designated investment firms. 'Insurers' includes the Society of Lloyd's (the Society) and Lloyd's managing agents, but not the individual members of the Lloyd's market.

(2) Section 2G of FSMA, added by the Financial Services Act 2012, provides that nothing in the PRA's statutory objectives is to be regarded as requiring the PRA to ensure that no PRA-*authorised person* fails.

(3) *The PRA's approach to insurance supervision* and *The PRA's approach to banking supervision*, available at www.bankofengland.co.uk/prapages/supervision/approach/.

(4) See section 74 of the Act. In the conditions below, 'the system of regulation' refers to the system as established by FSMA for the regulation of PRA-*authorised persons* and their activities (including regulation under relevant EU legislation), so far as it relates to the functions of the PRA.

- (b) events which had, or could have had, a significant adverse effect on the safety or soundness of the Society of Lloyd's and its members, taken together; and
- (c) events relating to the effecting and carrying out of contracts of insurance by the Society of Lloyd's or any other person who carries on PRA-regulated activities in relation to anything done at Lloyd's, which indicate a significant failure to secure an appropriate degree of protection to policyholders.

How the PRA will identify regulatory failure

11. In order to determine whether the conditions for an investigation into regulatory failure have been met, the PRA must:

- (i) assess whether relevant public expenditure, significant adverse effects on safety or soundness, or significant failure to secure an appropriate degree of policyholder protection have occurred; and
- (ii) assess whether those events were the result of a serious failure of the regulatory system or its operation.

If the PRA determines that both (i) and (ii) are satisfied, an investigation into regulatory failure will be required.

12. The fact that investigations will not be triggered automatically by relevant events reflects the important principle, rooted in the PRA's objectives, that it is not the PRA's role to prevent all firm failures, nor to protect all policyholders in full in all circumstances.

13. The matters which the PRA will take into account in its assessment of whether an investigation into regulatory failure is required are outlined below.

Relevant public expenditure

14. 'Relevant public expenditure' is defined by the Act, as being in broad terms:

- financial assistance provided, or expenditure incurred, by HM Treasury in respect of a PRA-authorized firm, for the purpose of resolving or reducing a threat to the stability of the UK financial system. This may include, for example, an injection of capital or funding into, or the provision of a guarantee to, a major insurer to prevent its failure;
- expenditure incurred by HM Treasury in the exercise of resolution and various other powers under the Banking Act 2009. This may include, for example, a loss incurred by HM Treasury in taking a bank into temporary public ownership and onward sale to a private sector purchaser;
- financial assistance provided, or expenditure incurred, by HM Treasury in respect of the Financial Services

Compensation Scheme (FSCS) in relation to a PRA-authorized firm. This may include, for example, a temporary loan to the FSCS allowing it swiftly to compensate the depositors of a failing bank.

15. 'Financial assistance' to a PRA-authorized firm includes guarantees or indemnities and any other kind of financial assistance (actual or contingent), but not indemnities or guarantees given by HM Treasury in respect of the provision of financial assistance by the Bank of England.

Safety or soundness and policyholder protection

16. The PRA must assess whether there has been a significant adverse effect on the safety or soundness of one or more PRA-authorized firms or a significant failure to secure an appropriate degree of policyholder protection. 'Safety and soundness' is assessed in the context of the PRA's general objective, which is advanced primarily by:

- (a) seeking to ensure that the business of PRA-authorized firms is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- (b) seeking to minimise the adverse effect that the failure of a PRA-authorized firm could be expected to have on the stability of the UK financial system.

The failure of a PRA-authorized firm would not necessarily satisfy the conditions for an investigation if there has not been a significant adverse effect on safety and soundness in this sense.

17. Subject to this, the PRA may judge that such events have occurred if:

- (a) a firm is in resolution or actively being wound up; or
- (b) solvency constraints have prevented an insurance firm from delivering on contractual obligations to policyholders, or from providing a level of payout to policyholders that the Financial Conduct Authority (FCA) considered fair;⁽¹⁾ or
- (c) there was an imminent risk to the viability of the firm such that events as described in (a) or (b) would have occurred but for the interventions or forbearance of a third party (for example, an acquisition or capital injection by a third-party institution).

18. In addition, even where a firm does not itself fail, if its behaviour has had a significant adverse effect on the stability of the UK financial system then this would satisfy the 'serious adverse effect on safety or soundness' requirement.

(1) For more information on the separate responsibilities of the FCA and PRA regarding with-profits policies, see the related Memorandum of Understanding agreed under section 3F of FSMA: www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf.

Serious failure in the scope or design of the system of regulation or its operation

19. If events as described above have been identified, an initial assessment will examine whether those events might have been avoided, or their severity been lower, but for a serious failure in the regulatory system or its operation. Where this is the case, an investigation will be required.

20. Serious failures of the regulatory system or its operation could fall into three broad categories:

- a failure in the design of the PRA's supervisory approach — in other words, that its approach does not deliver on its objectives; or
- a failure by the PRA to implement its supervisory approach effectively; or
- a failure in the scope or design of the framework of regulation, at a global, EU or domestic level, where these have prevented the PRA effectively from advancing its objectives.

21. As described in the PRA's policy documents on its approach to supervision, events that cause little disruption to the stability of the financial system or to policyholders are not necessarily inconsistent with the PRA's objectives. The PRA's approach has been designed on the basis that such events may occur, and if they do, they will not automatically imply regulatory failure.

22. Serious failures in the design of the PRA's supervisory approach must therefore be considered in the context of the PRA's statutory objectives. If events have occurred which are not inconsistent with the PRA's objectives — for example, the failure of a small credit union with no wider impact on financial stability, or a public loan to the FSCS in the course of orderly liquidation — then this would not automatically indicate a regulatory failure, since the PRA has designed its approach with a tolerance for such events in mind.

23. Other events that are inconsistent with the PRA's objectives, however — for example the disorderly failure of a systemically important firm with severe impact on financial stability — would be more likely to indicate a failure in the approach.

24. Serious failures by the PRA to implement its supervisory approach effectively will be identified and assessed in their own right. Such failures will be evidenced by, for example, the PRA failing to review basic regulatory returns which it has committed to analyse as a minimum baseline level of supervision, or more generally failing to undertake supervision as outlined in its published documents.

25. Serious failures in the scope or design of the framework of regulation will also be identified and assessed in their own right. EU legislation, for example, introduces binding rules to the United Kingdom, including some that implement standards agreed at a global level. Further powers and responsibilities are allocated to domestic supervisory bodies, including the PRA, by UK legislation. Potential defects in any element of this regulatory framework could restrict the PRA's ability to advance its objectives effectively, or lead to ambiguous areas of responsibility. While the PRA is committed to working with EU and global counterparts in establishing a robust prudential policy framework, in some cases its ability to offset any defects will be limited. In cases where the PRA believes that its ability to advance its objectives has been materially restricted by defects in the framework, the PRA will consider this to be a serious failure of the regulatory system.

Conducting investigations into regulatory failure and matters of public interest

26. An initial assessment examining whether relevant events were the result of a serious regulatory failure will be conducted by a part of the PRA not involved in supervision, and will be overseen by the PRA Board. The PRA Board will make the determination as to whether the requirement for an investigation is triggered.

27. Once a serious regulatory failure is judged to have occurred, an investigation will be initiated as soon as possible. Since investigations will be triggered only once the initial assessment is complete, however, they will inevitably not follow immediately from the events in question.

28. An investigation into matters of public interest will be triggered, and initiated as soon as possible, when the PRA receives a direction to that effect from HM Treasury.

29. The PRA will normally engage independent, external specialists in connection with its investigations. These specialists will report directly to the PRA Board. 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.

30. The PRA expects firms to deal with any investigation in an open and co-operative manner. This includes firms providing the investigator with the information necessary for it to carry out thorough investigations and produce comprehensive reports, enabling it properly to identify and address any

failures that may have occurred. While the PRA will look for firms' co-operation in the first instance, it may also use formal powers — in particular its information gathering powers — where it considers them to be an appropriate means of obtaining the necessary information. This may include circumstances where a firm is reluctant or unable to hand over information for reasons of confidentiality.

31. The investigating party will report directly to the PRA Board, which will have oversight of the process and be engaged throughout as necessary.

32. Should it be necessary, those subject to potential criticism in the report will be given an opportunity to make representations in response before it is finalised.

Postponing or suspending investigations

33. Under the Act, the PRA must have regard to the desirability of minimising any adverse effect that investigations may have on its other functions. This will include instances where the outcome of an investigation could prejudice an enforcement action being carried out by the PRA. In cases where the PRA considers that an investigation would prejudice its other functions, it may postpone the start of, or suspend, that investigation.

HM Treasury involvement

34. While it will be the responsibility of the PRA to determine how investigations are carried out, HM Treasury may give the PRA directions to control how an investigation is undertaken. In particular, HM Treasury may give the PRA directions controlling the scope of the investigation, the period of time in which it is to be carried out and how it is to be conducted. It may also give directions about how reports are to be made, including whether any interim reports are required.

35. The PRA will report to HM Treasury on the results of any investigation, setting out the lessons that it considers should be learnt and any recommendations it thinks appropriate. This includes identifying necessary improvements to the design or implementation of the PRA's supervisory approach, or the scope or design of the framework of regulation.

36. HM Treasury must publish the report, but will withhold material where it is required to do so by law or where it considers that this would be in the public interest. For example, HM Treasury may withhold material where confidentiality restrictions preclude publication, or where the report concerns ongoing events posing a risk to financial stability that could be aggravated by its release.