HM Treasury

Treasury Committee's review of the reports into the failure of HBOS:

government response

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by Command of Her Majesty

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Introduction

1.1 The Treasury Committee published their Review of the reports into the failure of HBOS[1] in July 2016. The Treasury Committee considered the findings of three previous reports into this subject by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), Andrew Green QC and the Treasury Committee's specialist advisers. The report sets out recommendations for the government and each of the regulators.

1.2 This document sets out the government's response to the relevant recommendations in the Treasury Committee's report. The regulators are responding separately.

Reports into the failure of HBOS

1.3 By the end of September 2008, HBOS was no longer able to meet its funding needs from the wholesale market and was facing a withdrawal of customer deposits. On 1 October 2008, the Bank of England provided HBOS with Emergency Liquidity Assistance so that the firm would be able to continue to meet its liabilities as they fell due.

1.4 The failure of HBOS has been the subject of a number of investigations, reviews and reports. The key dates are set out below:

- March and September 2012: the Financial Services Authority (FSA) published two enforcement notices regarding the oversight of the HBOS Corporate Division[2]
- September 2012: the FSA then commenced a review into the causes of the failure of HBOS, and into its supervision in September 2012, which was subsequently taken over by the new FCA and PRA
- February 2013: the TSC appointed two independent reviewers to oversee the drafting of the report that set out the review's conclusions
- April 2013: the Parliamentary Commission on Banking Standards (PCBS) produced its report on HBOS "An Accident Waiting to Happen"[3]
- January 2014: in response to concerns from the independent reviewers, Andrew Green QC was appointed by the regulators to lead an independent review of the FSA's enforcement actions on HBOS

1 Treasury Committee (2016), *Review of the reports into the failure of HBOS*, http://www.publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/582/582.pdf?utm_source=582&utm_medium=module&utm_campaign=modulereports

2 FSA (2012), *Final Notice for Bank of Scotland*: http://www.fsa.gov.uk/static/pubs/final/bankofscotlandplc.pdf and *Final Notice for Peter Cummings*: http://www.fsa.gov.uk/static/pubs/final/peter-cummings.pdf

3 Parliamentary Commission on Banking Standards (2013), *'An accident waiting to happen': The failure of HBOS*, http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/144/144.pdf

- July 2014: the Maxwellisation[4] process of the FCA/PRA and Andrew Green reviews began
- November 2015: the final FCA/PRA review[5], the accompanying Andrew Green review[6] and the evidence of the independent reviewers[7] were published

1.5 The Treasury committee's review of these reports includes a number of recommendations relating to the framework for financial regulation and enforcement and the conduct of future inquiries and investigations under the Financial Services Act 2012 (FSA 12).

The government's reform of the framework for financial regulation and review of enforcement decision-making

1.6 Since the financial crisis, and the failure of HBOS, the government has made significant reforms to the framework for financial regulation.

1.7 FSA 12 significantly reformed the institutional framework for financial regulation, abolishing the FSA, creating two new focused firm-level regulators, the FCA and PRA, and establishing the Financial Policy Committee within the Bank of England with responsibility for identifying, monitoring and taking action to remove or reduce systemic risks.

1.8 The government continued to take action to restore trust and credibility in financial services, including by: implementing recommendations of the Independent Commission on Banking and the Parliamentary Commission on Banking Standards, through the Financial Services (Banking Reform) Act 2013; creating new requirements for banks to ring-fence their retail banking activities; and a new Senior Managers Regime (SMR) to enhance the accountability of key decision makers in banks.

1.9 To ensure the FCA and PRA continue to make fair, transparent, timely, and efficient enforcement decisions, on 6 May 2014, the Chancellor of the Exchequer announced a HM Treasury review of the relevant institutional arrangements and processes of both institutions. This review included consideration of the institutional and governance arrangements for enforcement decision-making and the relationship between enforcement and supervision functions. The review reported in December 2014[8] and the regulators have accepted its recommendations, which included:

- a new independent decision-making committee for the PRA, with a dedicated and independent chair
- a new, sign-posted, expedited procedure to access the Upper Tribunal so that those who wish to access this independent judicial process can do so directly
- regular independent review of the regulators' settlement processes

[4] Maxwellisation is the process whereby the firm and any individuals subject to potential criticism are given an opportunity to make representations in response to the review's proposed findings.
[5] PRA and FCA (2013), *The failure of HBOS plc (HBOS)*, http://www.bankofengland.co.uk/pra/Documents/publications/reports/hbos.pdf
[6] Andrew Green QC (2015), *'Report into the FSA's enforcement actions following the failure of HBOS'*, http://www.bankofengland.co.uk/pra/Documents/publications/reports/agreenreport.pdf
[7] Stuart Bernau and Iain Cornish (2015), *'Evidence to the Treasury Committee by Stuart Bernau and Iain Cornish, Specialist Advisers to the Committee in relation to the FCA/PRA review into the failure of the HBOS Group'*, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/independent-review-of-the-report-into-the-failure-of-hbos/written/35021.pdf
[8] HM Treasury (2014), *Review of enforcement decision-making at the financial services regulators: final report,* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389063/enforcement_review_response_final.pdf

- measures to enhance the accountability of the FCA's and PRA's decision makers, including by publishing annual reports and increasing their accountability to Parliament
- the removal of penalty discounts where those being investigated delay settlement
- steps to encourage those being investigated to make early admissions to resolve cases more quickly
- the FCA and PRA should publish more information about their criteria for starting investigations, and their approaches to referring cases from supervision to enforcement, with more transparency around how the FCA and PRA co-operate with each other
- more constructive communication between investigators and those being investigated, with greater senior involvement by the regulators

The Financial Services Act 2012 regime for inquiries and investigations into possible serious regulatory failure

1.10 Since the HBOS review was initiated, the legal framework for investigations and inquiries in relation to financial regulation has also been significantly reformed. Transparency and accountability have been key elements of the government's reforms to the institutional framework for financial regulation. Part 5 of the FSA 12 provided for mechanisms to enable Treasury ministers to satisfy themselves that the regulatory system as a whole is functioning properly, and account to Parliament on that basis.

1.11 While retaining the power for Treasury to arrange independent inquiries, which were previously contained in FSMA provisions, the FSA 12 introduced a new provision, requiring that where there is possible regulatory failure, the regulators must make a report to the Treasury, which will then lay the report before Parliament. These new powers are particularly important to ensure transparency where there may have been a regulatory failure and ensure that lessons are learned. The legislation also gave the Treasury a power to direct the regulator to produce a report when that would be in the public interest. These powers are summarised in Box 1 (overleaf).

1.12 Such inquiries and investigations are intended to allow Treasury ministers to satisfy themselves that the regulatory system is functioning properly and to provide transparency to the public and Parliament. The Treasury retains powers of direction in relation to the scope, timing and conduct of such reviews, and the making of reports.

Box 1. The Financial Service Act 2012 Part 5 regime for inquiries and investigations into possible serious regulatory failure.

There are three main elements in the FSA 12 Part 5 regime for inquiries and investigations into possible serious regulatory failure:

Investigations

a) a requirement for the regulators to investigate and make a report to the Treasury, to be laid before Parliament, where there has been a serious failure in the system of financial regulation established in legislation, or in the operation of that system, and certain conditions are met (or the Treasury directs that they are met);

b) a power for the Treasury to require the FCA or PRA to undertake an investigation on public interest grounds in the absence of any investigation by the regulators; and

Inquiries

c) a power for the Treasury to order an independent inquiry into regulatory failure, carried out by a third party, where certain conditions are met.

1.13 It is for the regulators to decide how to carry out **investigations** under Part 5. The regulators have made clear that such reviews will be led by independent persons. The Treasury has the power to issue directions controlling the investigation. Both the regulators and the Treasury are under duties to have regard to the desirability of minimising any adverse effect of the carrying out of an investigation on the exercise of the supervisor's other functions.

1.14 The type of **inquiry** provided for by Part 5 is similar to the Chairman-led inquiry provided for in the Inquiries Act 2005. The independent third party is free to decide what evidence to look at, who to call to the inquiry, and responsible for determining procedure. As with investigations, the Treasury is able to issue directions controlling the scope, timing, and conduct of the investigation, and the making of reports. The costs of an inquiry are to be met by the Treasury from taxpayer funds.

The government response to the Treasury Committee's recommendations

1.15 Recommendation 1: 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. (Paragraph 50)

1.16 Part 5 of the FSA 12 makes provision for inquiries and investigations which can be initiated by the government and by the regulators. The government has therefore consulted the regulators on its response.

1.17 The government and the regulators agree that Part 5 inquiries and investigations should report in a timely way, and that consideration must be given to running reviews of this type in

parallel to disciplinary proceedings. The government and the regulators take a case by case approach to considering whether an inquiry or investigation under the FSA 12 Part 5 could begin, at least in part, alongside enforcement investigations.

1.18 It is clear that concurrent investigative work and publication of reports of Part 5 inquiries and investigations carry considerable risks, for example, in terms of the potential prejudice to disciplinary proceedings if the report was published before their conclusion, and the potential unfairness to a firm or individual to have to deal with interviews or requests for information in respect to an inquiry at the same time as dealing with an enforcement investigation or proceedings.

1.19 It may be possible to conduct earlier stages of Part 5 inquiries and investigations, such as a review of documentation, without the same risks. However, there would still be a necessary pause before proceeding to those later stages which could be prejudicial to disciplinary proceedings. In many cases, there is likely to be considerable uncertainty about the time disciplinary proceedings could take to complete and therefore the length of such a pause in the Part 5 investigation or inquiry. In each case consideration is given to the impacts on the cost and effectiveness of running a Part 5 investigation or inquiry in parallel to an enforcement investigation, including in relation to the government's or regulators' ability to appoint and retain an independent person to lead the reviews; and the potential benefits that might arise in terms of more timely reporting.

1.20 The government and the regulators also note that potential overlap with disciplinary proceedings is just one of the factors which have a bearing on the timing of investigations or inquiries. Other factors might include, for example, impacts on the supervision of the firm concerned.

1.21 The FSA 12 recognises the challenges the regulators may face in conducting parallel inquires and the following provisions of s78 FSA 12 are particularly pertinent:

"(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."

1.22 Recommendation 2: **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. (Paragraph 62)**

1.23 Under section 69 of the FSA 2012, the Treasury may order an independent inquiry into regulatory failure, carried out by a third party. Under this provision, the Treasury may appoint such a person as they consider appropriate to hold the inquiry. The Treasury may also, by a

direction to the appointed person, control the scope, period and conduct of the inquiry; the making of reports; and may require the appointed person to discontinue the inquiry.

1.24 The government believes that these provisions, which were debated and agreed by Parliament, continue to be appropriate. Part 5 of FSA 12 provides for mechanisms to enable Treasury ministers to satisfy themselves that the regulatory system as a whole is functioning properly, and account to Parliament on that basis. It is therefore important that the Treasury is able to direct the conduct and scope of these inquiries.

1.25 Clearly there are circumstances, such as where there is a need to avoid prejudicing enforcement action or criminal prosecution, where it will be appropriate to delay or suspend an inquiry. The government agrees that instances where it is necessary to discontinue an inquiry are likely to be exceptional, for example, where there may be public concerns over the conduct or cost of the review itself, or where there concerns of the review would be better dealt with by a wider or different inquiry.

1.26 The government does not believe the circumstances in which it may be appropriate to discontinue an inquiry can or should be exhaustively defined in statute. However **the government commits to make a statement to notify Parliament in the exceptional circumstances where an inquiry were to be discontinued.**

1.27 Recommendation 3: **In the meantime, steps must be taken to ensure that the independence of such inquiries is safeguarded in future. At a minimum, the Treasury should be required to gain agreement to the terms of reference from the person appointed to chair the inquiry and from the Treasury Committee. Such permission should also be sought if the Treasury seeks to discontinue an inquiry under the Act. (Paragraph 63)**

1.28 The FSA 12 Part 5 inquiry provisions form part of a framework intend to enable Treasury ministers to satisfy themselves that the regulatory system as a whole is functioning properly, and account to Parliament on that basis. **The government commits to consult the person appointed to lead such inquiries on the terms of reference, and to publish them after the commencement of the investigation to enable the Treasury committee to scrutinise them. However, the government believes it should remain ultimately accountable for the terms of reference of such inquiries.**

1.29 Recommendation 4: **Treasury Committee expects the Treasury to appoint an independent reviewer to re-examine the case for a separate enforcement body. (Paragraph 163)**

1.30 The Treasury's December 2014 report on enforcement decision-making at the financial regulators considered the case for separating enforcement and supervision functions, and the issues raised by the PCBS. The relevant section from the report in which the Treasury responded to the PCBS recommendation is reproduced in **Box 2 below**.

Box 2: The supervision and enforcement interface[9]

"Striking an appropriate balance between supervisory intervention and enforcement action is a critical issue for regulators, and relies on co-ordination between the 2 functions.

[9] HM Treasury (2014), Review of enforcement decision-making at the financial services regulators: final report, p 10, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389063/enforcement_review_response_final.pdf

The PCBS referred to the *'risk of conflicts of interest'* between supervision and enforcement functions, and contemplated whether there may be merit in institutional separation, and in the creation of an enforcement organisation independent of the regulators. It was considered that a separate enforcement body, *'could help address the possibility of conflict or missed opportunities from divided responsibilities between the FCA and PRA…would have clearer objectives and accountability…[and] could address the risk of conflicts of interest with supervisors and could find it easier to initiate investigations without a referral from supervisors.*

Ultimately, however, the PCBS considered that institutional separation would prove too disruptive, in the immediate aftermath of the FCA and PRA assuming the responsibilities of the FSA. The PCBS also identified that, *'an independent enforcement body could still be reliant on supervisors for many referrals, which could result in fewer cases if there were any problems co-operating with the FCA or PRA.'*

It is clear that there is the potential for tension between the enforcement and supervision functions. The most obvious source is where, an apparent breach of the regulatory requirements having emerged, supervisors consider that a referral for enforcement investigation might be justified, but might impact negatively on their objectives for the firm.

For example, suspected misconduct at a firm may be serious. But, if it pre-dates the arrival of a new senior management team which supervisors consider to be effecting significant organisational and cultural change, then, depending on the circumstances of the misconduct, a question arises as to whether enforcement action is appropriate or whether it may divert the attention of the firm's senior management and so potentially hamper its reforms, in which case a supervisory response might be preferable. That is an entirely legitimate question which must be given appropriate consideration by the regulators.

Supervisors may be more likely to view the breach within the context of their deep understanding of the firm's regulatory history and current approach to compliance. Enforcement staff may be more focused on the specifics of the misconduct and its wider impact.

In those circumstances, it is imperative that a balanced decision is taken in the round, to ensure that the regulator identifies the right regulatory response, consistent with its statutory objectives; whether that is an enforcement investigation, a supervisory response or enforcement and supervision staff working together with a firm to ensure that it takes the appropriate steps to address identified risks.

Full co-operation is therefore a pre-requisite. Issues discovered by supervisors and potentially warranting investigation must be flagged to enforcement staff in the first instance. And once enforcement staff have begun an investigation, supervisory input is critical to assisting enforcement staff's understanding of a firm's business and relevant market practice. Matters discovered by enforcement staff in the course of an investigation will often be relevant to ongoing supervision, and vice versa.

Co-operation between the supervision and enforcement functions is likely to be imperilled by institutional separation. Distinct organisations would have different objectives and divergent priorities. It would become harder for those organisations to identify the right regulatory response to a suspected breach. The practical and legal issues arising from separation – for example, in terms of information sharing – would potentially impair the efficient, effective delivery of that response.

Internationally, it is not clear that there are any jurisdictions where the principal financial services regulators' administrative enforcement functions are institutionally separate from the supervisory function. Indeed, at some overseas regulators, the enforcement function sits within the supervisory function.

In the US, the Securities and Exchanges Commission (SEC) implemented a significant reform programme in the wake of delays in identifying the fraud perpetrated by Bernard Madoff. This was in part directed at weaknesses in communication and co-ordination, including between the SEC's enforcement and examination (akin to supervisory) functions. In evidence before a US Senate Committee, a senior SEC official commented that, *'In the Madoff matter, this lack of effective co-ordination resulted in missed opportunities, miscommunications, and a failure to share knowledge and evidence.'*

But aside from the benefits of shared knowledge and evidence in individual cases, there are clear advantages to locating the supervisory and enforcement functions within the same organisation, and sharing the same priorities. Supervisors will be the first to identify behavioural trends or recurring issues, in a particular sector, which lead to risks. Those risks can then inform strategic priorities; and, potentially, addressing those risks may call for enforcement action as a public deterrent to others in the industry. Therefore, co-ordination is key, if the regulator is to respond quickly and proactively to emerging risks. Locating the supervision and enforcement functions in the same organisation, with shared, organisational priorities, optimises co-ordination, and the ability to deliver the right regulatory response.

The government's view is that inevitable tensions between the roles of supervisors and enforcement staff are best resolved where those staff are situated in the same organisation with a clear, unitary set of organisational objectives and priorities. As set out in chapter 4, there is, in fact, a good case, in appropriate instances, for closer co-operation and involvement of supervisors in enforcement investigations than may currently take place.

It is at the decision-making stage, and where there is a clear dispute between the subject and the regulator, that the importance of independent judgment, and its perception, require appropriately independent decision-makers. The issue of objective, independent decision-making is considered further at chapter 6."

1.31 The government does not believe that the creation of a separate enforcement body is merited. As the Treasury review noted there is a significant need for co-operation and co-ordination between supervisory and enforcement functions which is best served by combining these functions in one organisation. Locating the supervision and enforcement functions in the same organisation, with shared organisational priorities, optimises co-ordination, and the ability to deliver the right regulatory response, including important early intervention work carried out jointly by Supervision and Enforcement.

1.32 Although having a separate criminal prosecutor to a regulator is common, the government is not aware of any financial services regulator that does not have the power to punish breaches of its own rules. Having a separate body would mean that the issues it was made aware of, and the work referred, would be the decision of the supervisor. Conversely, the enforcement body would have to have the discretion to decide which cases to accept, which could potentially leave the supervisor toothless.

1.33 In the government's view, the Green report serves to highlight the need for appropriate co-ordination between supervision and enforcement and strengthen, rather than detract from the case for the current model. This view appears to be supported by Andrew Green QC's

recommendation for increasing Enforcement-Supervision cooperation through regular quarterly meetings.

1.34 Finally, the government notes that there was little appetite from those who responded to the consultation carried out in the course of the Treasury's review for structural separation of the kind envisaged by the Treasury Committee.

1.35 Accordingly, **the government does not propose further reform to separate out the enforcement function and does not believe that a further taxpayer funded independent review so soon after the Treasury's detailed review is justified.**

1.36 However, it is important that regulators remain alive to the risks around the effective coordination of the supervision and enforcement functions and manage them effectively within the existing framework.

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