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Bank of England Bill Team
HM Treasury
1 Horse Guards Road
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25 September 2015

Dear Sirs

HM Treasury: Bank of England Bill – technical consultation

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

HM Treasury published on 21 July 2015 a technical consultation on proposals in the Bank of England Bill that are intended to strengthen the Bank's governance, transparency and accountability, enhance the ability of the Bank to discharge its macroprudential, micro-prudential and monetary policy responsibilities in a co-ordinated way, and ensure that the UK's crisis management arrangements keep pace with developments in resolution policy.

Further to our letter of 11 September 2015, please find below our comments in full in response to the proposals.

1. The Proposal

The technical consultation adopts the proposal set out by the Bank on 11 December 2014, in its paper Transparency and Accountability at the Bank of England, to simplify the constitution of the policy committees by adopting the structure of the MPC for the PRA and the FPC.

The PRA is a private limited company which is a subsidiary of the Bank of England. The proposal to make the PRA coordinate to the MPC would involve the following:

- Dissolution of the PRA private limited company;
- Establishing a new committee, the Prudential Regulation Committee, within the Bank; and
- Making the Bank responsible for what are currently the statutory responsibilities of the PRA.

2. Concerns with the Proposal

Operational independence

It is imperative that the PRA continue to benefit from operational independence. Principle 2 of the Basel Committee's Core Principles for Effective Banking Supervision sets out the requirement for a supervisor to possess operational independence. Article 3 of the Bank Recovery and Resolution Directive requires that adequate structural arrangements be in place to ensure operational independence of the resolution function and the supervisory or other functions, and to avoid conflicts of interest between those functions.

The current status of the PRA as a separate company protects the operational independence by making its directors subject to certain provisions of the Companies Act 2006. The general duties of directors set out in the Companies Act 2006 enshrine in statute the fiduciary requirements of directors towards their company developed in the common law. They have the fundamental purpose of ensuring that a company's directors are loyal to that company and unimpeded by outside interests. The following general duties are particularly pertinent:

- Section 171 requires directors of a company to act in accordance with the company's constitution and only exercise powers for the purposes for which they were conferred;

- section 172 requires directors of a company to act in a way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole which, pursuant to section 172(2), includes purposes other than the benefit of its members, where such a purpose exists in relation to the company. The objects of the PRA are set out in its articles of association at article 6 as being "to act as prudential regulator for financial firms under and in accordance with the duties and responsibilities conferred upon the company by any applicable law";

- section 173 requires that directors of a company must exercise independent judgment;

- section 175 requires directors of a company to avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. Conflicts of interest referred to in this section include conflicts of interest and duty and conflicts of duties.

These duties, and the liability directors expose themselves to by breaching them, create a structural safeguard for the operational independence of the PRA. Folding the PRA into the Bank would remove this structural protection. The technical consultation states that:

- "through the Bill, the government intends to end the PRA's status as a subsidiary and fully integrate the PRA into the Bank, while recognising the PRA's operational independence, in line with the Basel Core Principles on Supervision";

- "updated reporting requirements will ensure supervision continues to operate with appropriate independence and adequate resources";

- "the Bank will be given a duty to publish a policy statement setting out the steps it has taken to ensure that there is appropriate structural separation and independence between the Bank's resolution functions and its new prudential supervision functions, to prevent conflicts or interests, and as a requirement of EU law".

While recognition of the importance of the operational independence of the PRA is welcome, more clarity is needed in terms of how this operational independence will be implemented and maintained. Detail is required as to the nature of the updated reporting requirements. More specificity is also needed in relation to the policy statement to be required of the Bank. It is one thing if this is a requirement in advance of the folding of the PRA into the Bank which can be judged before the changes go ahead, and quite another if this is simply to be published by the Bank after the fact.

The following conflicts of interests may arise if proper structural separation is not maintained between the PRA as microprudential supervisor and the Bank:

(1) conflict between microprudential and macroeconomic objectives;

(2) conflict between microprudential and resolution objectives.; and

(3) conflict between microprudential and macroprudential objectives.

The first conflict would arise as a result of the Bank, already responsible for monetary policy, being given the additional responsibility of supervising individual firms. An example of a potential instance in which monetary policy and microprudential supervisory objectives may not align is at a time of stress, when a central bank responsible for both may be hesitant to impose appropriate tightening due to concern for solvency of the individual firms it supervises.

The second conflict would arise because the Bank is already the resolution authority. One would want to avoid the risk that the PRA have its analysis of whether an institution should be resolved influenced by the entity which is responsible for undertaking that resolution. This could result in an inconsistent approach to an already inherently subjective decision.

The third conflict would arise because the Bank is already responsible for macroprudential policy through the FPC, currently a sub-committee within the Bank. Under the proposals set out in the technical consultation, the Bank would contain the PRC and FPC as coordinate committees. One conceivable example of a conflict of interests between microprudential and macroprudential objectives is that a macroprudential supervisor may want to reduce capital buffers during a downturn in order to reduce the probability of a credit crunch, while a microprudential supervisor is likely to prefer to maintain the integrity of individual firms by maintaining higher capital requirements.

It is also worth mentioning at this point the importance of avoiding not only an actual conflict of interest but also an appearance of conflict. This is set out by Essential Criterion 4 in relation to Core Principal 2 of the Basel Committee. The structural separation of the PRA from the Bank helps to provide a visible separation and reduce the perception of a conflict of interests.

There is a risk that the removal of this institutional barrier will increase the perception of a conflict of interests and thereby undermine the perceived independence of the regulator and consequently its credibility.

We note that the operational independence of the Single Supervisory Mechanism (SSM) at the ECB is the subject of robust protection. The Supervisory Board of the SSM is composed of one representative from each National Competent Authority (NCA) as well as four representatives of the ECB, the Chair and the Vice-Chair. While it is the ultimate decision of the Governing Board whether to adopt a proposal from the Supervisory Board, it has the power only to accept or decline a proposal; it cannot alter a proposal or formulate a proposal itself. The presence of members from the NCAs provides a check to ensure that the SSM carries out its primary objective free from other interests at the ECB. The Joint Supervisory Teams responsible for supervising significant institutions also contain staff from the NCAs of the countries where the relevant institution is established, alongside ECB staff, and less significant institutions are supervised indirectly through the NCAs.

The Administrative Board of Review (comprising five independent members who are not staff of ECB or any NCA) also exists to carry out internal administrative reviews of ECB decisions in the exercise of its supervisory powers.

Accountability of the PRA

The PRA is subject to audit by the NAO. It is proposed in the technical consultation that NAO oversight be extended to the Bank itself. While we have reservations regarding the need to fold the PRA into the Bank, we support the conclusion that the Bank should be brought under the NAO's audit regime if the PRA is subsumed within the Bank. Not doing so would reduce accountability.

3. Summary

It is imperative that more detail is provided as to how the operational independence of the PRA would be guaranteed were it to be folded into the Bank. This would more properly demonstrate the suitability of the proposed policy and organisational protections which would be replacing current structural protections. Failing this, the risks involved in tampering with a structure that has been effective in ensuring the operational independence of the PRA must be said to outweigh the benefits of the proposed institutional simplification.

It is not obvious that there has been any change since the formation of the PRA in 2011 that alters the original rationale for its incorporation as a private limited company. We note that the model of the MPC was available at that juncture but not used, and that in the July 2010 consultation 'A new approach to financial regulation: judgement, focus and stability' the following was stated at paragraphs 2.17 and 2.18:

> "The Government will therefore legislate to create a new Prudential Regulation Authority (PRA) which, while operating under the auspices of the Bank of England, with a board chaired by the Governor, and a chief executive who will also occupy the newly created post of Deputy Governor of the Bank for prudential regulation, will nevertheless be a separate legal entity.
>
> This will ensure that the day-to-day operations of firm-specific regulation will be undertaken by the new PRA, rather than falling to the Bank itself."

If the PRA is folded into the Bank, we would support the proposal to bring the Bank itself under the audit regime of the NAO. This is essential to ensure continued accountability in relation to the use of resources if the PRA were to no longer exist as a separate entity.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at karen.anderson@hsf.com, or Peter Richards Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, in the first instance.

Yours sincerely

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