

**ABSTRACT**

*This paper considers the need for a more pro active approach which facilitates greater on site work being carried out by supervisors – as highlighted in the Legal and General Case. It also considers the recommendations made to the UK's regulator - the FSA, and in particular to the FSA Board, following the Legal and General Case. The recommendations are compared to the Basel Committee's Core Principles for Effective Banking Supervision. In drawing a comparison, the importance of independent verification of work carried out by external auditors, be it through on-site examinations or the use of external experts, is once again emphasised. The involvement of external auditors or other experts in the supervisory process should not relieve a regulator from on site supervisory responsibilities. As vital as an external auditor's work is, it is also important to verify such work.*

## **THE NEED FOR GREATER PRO ACTIVE INVOLVEMENT BY REGULATORS IN FINANCIAL REGULATION AND SUPERVISION: LESSONS FROM THE LEGAL AND GENERAL CASE**

An extension of the external auditor's role depends on the nature and environment of the national supervisor.<sup>1</sup> For example, the assistance that might be required of the external auditor will usually be minimal where the banking supervisor follows an active approach, with frequent and rigorous inspection.<sup>2</sup> If however, there has been a history of less direct supervision, which is mainly based on the analysis of reported information provided by bank's management, as opposed to inspection, or if supervisory resources are limited, the assistance that the external auditor can offer in providing assurance on the information obtained could be of immense benefit to the supervisor.<sup>3</sup>

Many countries however, are currently practising a supervisory approach which combines elements of inspection and analysis of reported information.<sup>4</sup> Inspection is proving more and more demanding in terms of supervisory resources even as banking becomes more complex.<sup>5</sup> As a result, many supervisory authorities that practice on-site inspection are being driven to place greater reliance on reported information, and look to the external auditor for assistance in those areas for which the auditor's skills are particularly suited.<sup>6</sup>

In countries where banking supervisors have previously relied on their analysis of prudential returns, they have found that a certain degree of on-the-spot examination is a desirable safeguard, therefore in these countries, the supervisors are relying more than ever before on external auditors to assist them by performing specific tasks. Whereas in those countries where communication between external auditors and banking supervisors have been close over a long period, a bond of mutual trust has been built up and extended experience of collaboration has enabled each to benefit from the other's work. Experience in those countries also indicates that the conflicts of interest that auditors may in principle perceive as preventing close collaboration with supervisors assume less importance in practice and do not present an obstacle to a fruitful dialogue.

The Basel Committee for banking supervision has highlighted the need for a continuing dialogue between banking supervisors and the accountancy/audit profession.<sup>7</sup> Other reasons for the need of external auditors include:<sup>8</sup>

- 1) Banking supervisors need to be making greater use of external auditors if they are to meet the requirements of the Basel Principles (Core Principles for effective Banking Supervision)
- 2) The increasing supervisory focus on corporate governance and on internal controls will require supervisors to take account of the views of external auditors
- 3) The increasing sophistication of control and risk management systems requires the expertise of external auditors
- 4) Increased reliance on IT systems requires the expertise of external auditors
- 5) Move of banking supervision to oversight of process rather than detailed examination requires skills which can be provided by external auditors

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<sup>1</sup> „The Relationship between Banking Supervisors and Banks' External Auditors: Additional Requests for the External Auditor to Contribute to the Supervisory Process' January 2002 (page 12) paragraph 64: also see <<http://www.bis.org/publ/bcbs87.pdf>>

<sup>2</sup> *ibid*

<sup>3</sup> *ibid*

<sup>4</sup> *ibid* paragraph 65

<sup>5</sup> *ibid*

<sup>6</sup> *ibid*

<sup>7</sup> The Role of External Auditors in Financial Services Supervision, Report by Pricewaterhouse Coopers

<sup>8</sup> Basel Core Principles for Effective Banking Supervision 1997, Basel Committee Publications No 30 (September 1997); <http://www.bis.org/publ/bcbs30a.htm>; also see „The Relationship between Bank Supervisors and External Auditors“, Basel Committee Publications No 87 January 2002

- 6) The perception of a conflict of interest between the role of reporting to shareholders and that of reporting to supervisors is more apparent than real and is addressed by appropriate guidance and standards, including principles laid down by the Basel Committee.

In jurisdictions where greater use of external auditors is required (and also in cases where there is less need of external auditors), this should not serve as justification for a corresponding degree of reliance on such external auditors' work. In jurisdictions where the banking supervisor follows an active approach, such direct involvement in the supervisory process should be maintained and greater involvement encouraged. In those jurisdictions where there is greater need for external auditors (where less direct supervision is undertaken by supervisors), this should indicate the need for safeguards – in the form of greater proactive involvement by banking supervisors in the supervisory process.

#### Off-site and On-site Systems of Supervision

According to the Core Principles<sup>9</sup> for Effective Banking Supervision 1997, an effective banking supervisory system should consist of some kind of both “on-site” and “off-site” supervision.

#### Offsite Supervision

Off-site supervision is synonymous with monitoring and involves the regulator making use of external auditors. It also involves the receipt and analysis of financial statements and statistical returns submitted to the supervisors.<sup>10</sup> Such analysis of the information promotes the monitoring of each bank's performance and the observance of supervisory requirements from time to time.<sup>11</sup> Off-site monitoring often has the benefits of being able to identify potential problems, particularly during intervals between on-site inspections, thereby providing early detection and acting as trigger for corrective action before problems become more serious.<sup>12</sup>

#### Onsite Supervision

On-site work is usually done by the examination staff of the bank supervisory agency or commissioned by supervisors but may be undertaken by external auditors.<sup>13</sup> On site supervision is synonymous with inspections and as well as providing on-site checks on a bank's operations and condition, they enable off-site supervision data to be verified.<sup>14</sup> With the use of samples instead of full audits, inspectors can concentrate on the bank's accounting and control systems, its compliance to policies and procedures and arrive at conclusions about management capabilities<sup>15</sup>. At present, the external auditor assists the FSA through a mixed system of supervision whereby the FSA inspects banks (on-site) and utilises external auditors (off-site). The systems in the UK and Germany<sup>16</sup> involve both on-site and off-site supervision whilst Italy to a greater degree, is based on the on-site system

<sup>9</sup> Principle 20, Basel Core Principles for Effective Banking Supervision, Basel Committee for Banking Supervision, Bank for International Settlements, Basel, September 1997

<sup>10</sup> D Quiroz Rendon, 'The Formal Regulatory Approach to Banking Regulation' Badell & Grau Legal Consultants, see <<http://www.badellgrau.com/legalbanking.html>> (last visited 10 June 2008) pg 20 of 26

<sup>11</sup> ibid

<sup>12</sup> 'The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 40 page 11 see <<http://www.bis.org/publ/bcbs87.pdf>> (last visited 11th July 2007)

<sup>13</sup> 'The Relationship between Bank Supervisors and External Auditors' (Basel Committee Publications No. 87 January 2002)

<sup>14</sup> D Quiroz Rendon, 'The Formal Regulatory Approach to Banking Regulation' Badell & Grau Legal Consultants, see <<http://www.badellgrau.com/legalbanking.html>> (last visited 10 June 2008) pg 20 of 26

<sup>15</sup> ibid

<sup>16</sup> For Germany, see Gesetz ueber das Kreditwesen, <<http://www.bafin.de/gesetz/kwg.htm>> (12 Aug 2005); Gesetz ueber die Bundesanstalt fuer Finanzdienstleistungsaufsicht, section 1 (Erster Abschnitt) <<http://www.bafin.de/gesetze/findag.htm>> (12 Aug 2005)

(even though it still makes use of external auditors). The US position is based on an on-site system of supervision and is focussed on the aim of using external audit to examine financial institutions, but it does not extend beyond that (as it does in the UK where extra auditor functions are acquired).<sup>17</sup>

It should be emphasised that pro-active involvement by regulators does not merely infer greater on-site supervisions but also the actual involvement of regulators in the supervisory process. A more proactive approach role to regulation was suggested by Mr Ronald Baker, an ex Head of Financial Products Group, Barings Investment Bank.<sup>18</sup> In this report, Mr Baker gave his experience of working for American banks – that there was a more proactive role taken by the regulators in New York in terms of having people on the trading floor. In the US, periodic on-site examinations are carried out and justified on the basis of the large number of small banks and on unit banking within particular states.<sup>19</sup> Unlike jurisdictions where authorities place reliance on outside experts, bank supervisors in the US must possess skills in order to evaluate asset quality and other areas governing a bank's activities.<sup>20</sup> The disadvantage in this is that it can be labour intensive and restricted by budgetary constraints.<sup>21</sup> US supervisory authorities have responded to resource constraints in recent years by making greater use of off-site surveillance systems.<sup>22</sup> However, the use of off-site surveillance systems could also be disadvantageous as computers cannot observe certain aspects of examinations, namely, the scrutiny of management practices.<sup>23</sup>

#### Enforcement of Accounting/Audit Principles

Enforcement can be defined as all procedures in a country in order to assure the proper application of accounting principles. Enforcement procedures are necessary in order to ensure that accounting and regulatory standards are being complied with. A good compliance culture can be defined as one which functions in accordance to the regulatory standards imposed on it. Enforcement can also be considered to be a constitution of several components such as clear accounting standards, prompt interpretation and implementation guidance, statutory audit, monitoring by supervisors and effective sanctions. Although all these components are important and each of these need to work effectively, the statutory audit function, which ensures appropriate application of accounting standards, has to be carried out according to uniformly high standards across the EU.

The enforcement of audit standards appears in most European countries at 6 levels namely:

Preparation of financial statements

Statutory audit of financial statements

Approval of financial statements

Institutional oversight systems

Court: sanctions and complaints

Public and press reactions

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<sup>17</sup> More information on this : D Singh 'Banking Regulation of UK Financial Markets'

<sup>18</sup> Barings Bank and International Regulation, Minutes of Evidence, Tuesday 23 July 1996 at page 101

<sup>19</sup> V Polizzato, 'Prudential Regulation and Banking Supervision: Building an Institutional Framework for Banks' (1990) World Bank Working Paper January 1990 at p 17

<sup>20</sup> *ibid*

<sup>21</sup> *ibid*

<sup>22</sup> *ibid*

<sup>23</sup> See 'Off-site Surveillance Systems' < <http://www.fdic.gov/bank/historical/history/vol2/panel2.pdf> >

(last visited 15 February 2009). Also see advantages and disadvantages of Off site Monitoring on pp 479, 480

## The Role of Courts in the Enforcement Process

In addition to *Re Pearl Assurance (Unit Linked Pensions) Ltd* and *Re: Hill Samuel Life Assurance Limited, Re Equitable Life Assurance Society*,<sup>24</sup> further defined the role not only of the independent expert, but also of the Court in deciding whether or not to exercise its discretion. The facts of Equitable Life are as follows: Equitable Life, an insurance company, made an application for a sanction of a transfer scheme, under section 111 of the Financial Services and Markets Act 2000 (FSMA).<sup>25</sup> The Transfer Scheme involved the transfer of part of the insurance business being conducted by Equitable Life to Canada Life. The FSA had been consulted in the preparation of the Scheme. Even though Canada Life's ultimate parent company was incorporated in Canada, because Canada Life was authorised to carry on insurance business in the UK by the FSA, it was subject to the FSA's supervision. An independent expert, a partner in KPMG LLP, was authorised by the FSA to assess and report on the Scheme. It concluded that the different categories of policyholders would not be affected adversely by the Scheme. Hence, the FSA considered the Scheme to be satisfactory. In considering whether it was appropriate to sanction the Scheme, the Court not only referred to sections 105, 111, 112 FSMA, but also the leading authority of *RE London Life Association Ltd* where the Insurance Companies Act 1982 schedule 2c, predecessor of section 111 FSMA was considered. Applying the same principle used in that case, the Court decided that since the scheme on the whole was fair, it would make no alterations just because of certain individual provisions.

It was stated in *Re Equitable* that the process culminating in the Court's sanction was designed to ensure that the transfer scheme was fair to those relying on the parties to the arrangement to provide their pensions, namely the policyholders. In addition, it was stated that it was to ensure such fairness that the FSA has a supervisory role and appointed an independent expert to rely on the scheme. The Court therefore was not convinced by various submissions of policyholders that the views of the independent expert should be disregarded and that the Court's sanction to the Scheme was to be refused. Mr Justice Rimer's statement in *Re: Hill Samuel Life Assurance Limited*, illustrates the importance of the role of an independent expert. Where the Court considers the report or opinion of the expert as sufficient, it could be difficult for various submissions, including those of the FSA, to succeed. This is further illustrated in *Legal and General*. In *Legal and General*, even though the court agreed that the FSA was justified in asserting that *Legal and General* had in certain cases misold low cost with profits endowment policies, this was only justified in relation to those cases. The FSA's claims regarding the extent of the mis-selling was not accepted as there was insufficient proof to provide such justification. In other words, the Court chose to rely on the opinion of the external auditor who had carried out the assessment and who had arrived at the conclusion the sample size used was not representative enough.

Enforcement by the UK's financial services regulator (the FSA)

Enforcement by the FSA

The FSA, in considering disciplinary action, has tried to focus on the organisation concerned as opposed to individuals.<sup>26</sup> At the same time, considerable efforts are being made to highlight concerns

<sup>24</sup> [2007] EWHC 229 (Ch)

<sup>25</sup> Section 111 FSMA lists the requirements to be fulfilled before a court may grant an order sanctioning an insurance business transfer scheme or a banking business transfer scheme. Section 105 FSMA provides the requirements in order to be classified as an insurance business transfer scheme. Sections 105 and 111 constitute part of Part VII of the FSMA which deals with the control of transfers of insurance businesses. Equitable also sought ancillary orders under section 112 of the Act.

<sup>26</sup> R Turner 'The Interaction between FSA Enforcement Action and Compliance Culture: A Help or a Hindrance?' *Journal of Financial Regulation and Compliance* Volume 13 Number 2 2005, Henry Stewart Publications at p 144

which emanate from the apparent lack of management oversight.<sup>27</sup> The difficulty in reconciling the desire of senior management to operate a compliant business and the ability of the organisation to deliver according to the standards expected by the FSA has been attributed partly to inadequate training, processes or understanding of allocated responsibilities.<sup>28</sup>

In order for the enforcement tool to be effective, it must justify the act for which it has been imposed. As mentioned previously, the public “naming and shaming” by means of press communication is very effective as companies will try to avoid their name and reputation from being tarnished. However, as the *Legal and General Case* has highlighted, not all regulated institutions may accept such sanctions. Following the *Legal and General Case*, an Enforcement Process Review was set up to review the use of, approach to and decision-making process for supervisory actions and enforcement actions to address breaches of regulatory requirements and, where appropriate, to make recommendations.<sup>29</sup> The review evaluated the lessons from the FSA’s experience over the last three years under the Financial Services & Markets Act 2000 (FSMA) regime including the comments of the Tribunal in the Legal & General case but did not explore any options which would require changes to FSMA.<sup>30</sup> The review considered the procedures followed by supervisors, enforcement staff and decision makers in considering possible breaches of statutory or regulatory requirements, and the nature and extent of the communications and interactions between them; the role and involvement of senior FSA management throughout these processes; options for making regulatory decisions based on a fair procedure by persons separate from the investigators; and the accountability of decision makers to the FSA Board.

Recommendations made to the FSA Board following the *Legal and General Case* include four key principles for the FSA’s enforcement process review that have driven the Review’s recommendations and these are:<sup>31</sup> That the FSA should provide: a clear view of its holistic approach to the use of enforcement; adequate safeguards and controls to help ensure balance and fairness during the investigation phase<sup>32</sup>; transparency for those subject to enforcement action so that they are well-informed about the case they have to answer and the evidence on which it is based; and clarity as to the distinction (required by FSMA) between those who investigate a case and those who decide<sup>33</sup>.

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27 *ibid*

28 *ibid*

29 <[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)> at p 65

30 *ibid*

31 <[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)> pp 13 -15 (last visited 10 October 2008)

32 As the FSA is a risk-based regulator, it has to focus its limited resources on those issues which are likely to have greatest impact on its statutory objectives. As a valid enforcement tool, a practical consequence of the risk based approach is that the FSA cannot, and does not, attempt to investigate every rule breach. The FSA instead, selects cases carefully, according to their seriousness and its priorities. The Review recommends no change to this approach but it is important that the FSA continues to explain how it will use enforcement to help meet its objectives and what the practical consequences of this are for firms and consumers.

To help facilitate the decision-making process functions most effectively, investigations must be of a high quality and any alleged breaches properly supported by evidence. A number of recommendations to strengthen the investigation process and one which is particularly recommended by the Review, is that before a case is referred to the decision makers, there be a thorough legal review by lawyers in the Enforcement Division who are not part of the investigation team. This is not generally current practice; *ibid*

33 In order to operate fairly and in order to be seen as operating fairly, there must be separation between those who investigate possible rule breaches and those who decide whether the conduct in question should be sanctioned within the FSA’s enforcement process. This fundamental distinction in respect of decision-making is required by FSMA, but its terms are sufficiently wide to allow the FSA considerable flexibility as to how it achieves this.

Currently, the FSA facilitates this separation by entrusting the more foundational and contentious regulatory decision making to the RDC. The RDC is a Committee of the FSA’s Board, but operationally independent of it. Apart from the Review recommending that the RDC be maintained and that its membership continue to include practitioners and non-practitioners, the FSA Board is also to maintain its current policy of non intervention in, or attempting to influence, the RDC’s individual decisions; *ibid*

Other recommendations include the fact that the FSA is to continue to promote transparency about its risk-based approach to enforcement and the consequences flowing from it, particularly for case selection.<sup>34</sup> The FSA Board and the Executive are to consider at least once a year, the approach to enforcement and how this tool can be utilised to help achieve its overall objectives.<sup>35</sup> The FSA's enforcement approach for medium-sized and smaller firms is also to be developed and communicated to complement its approaches for the larger and for the smallest firms.<sup>36</sup>

Comparing the Recommendations to the Basel Committee on Banking Supervision 'Core Principles For Effective Banking Supervision' October 2006

*Principle 1 – Objectives, independence, powers, transparency and cooperation:* An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

The principle which influenced the review's recommendations that the FSA should provide sufficient measures during the investigation phase of the enforcement process to deliver balance and fairness, transparency for those subject to enforcement action, and clarity as to the separation between those who investigate a case and those who decide it<sup>37</sup> is similar to principle 1 of the Basel Core Principles. The review's decision to maintain the Regulatory Decisions Committee (RDC) was also aimed at promoting accountability.<sup>38</sup> Specific recommendations relating to the RDC were also aimed at ensuring that there were no longer confidential communications between Enforcement and the RDC.<sup>39</sup>

*Principle 21 – Supervisory reporting:* Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Several respondents believed that senior management from Supervision and Enforcement should have a greater involvement in the enforcement process and that this would immensely improve the perception of fairness.<sup>40</sup> As regards the involvement of supervisors during the investigation phase, supervisors of a firm are not as a general rule, directly involved in an investigation which is being pursued by Enforcement.<sup>41</sup> This approach has its advantages in maintaining a clear division between the conduct of the investigation on the one hand and the need to maintain the supervisory relationship with the firm on the other.<sup>42</sup> At the same time this division of responsibility may mean that the investigation does not benefit as much as it might otherwise do from the knowledge of the firm or individuals that the supervisor will have built up, nor from the general understanding of the firm's business or sector that the supervisor may be able to contribute.<sup>43</sup>

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34      ibid p 29

35      ibid

36      ibid

37      See <

<http://www.lovells.com/Lovells/MediaCentre/PressBriefings/FSA+ENFORCEMENT+REVIEW.htm>>

38      The Review found that the RDC was effective in providing clear separation between those who investigated possible rule breaches and those who decide whether the conduct in question should be sanctioned; ibid

39      ibid

40      <[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)> p 83

41      <[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)> p 30

42      ibid p 30

43      ibid

In relation to a number of recommendations concerning matters beyond the role and operation of the RDC, the review recommended that before a case is referred to the decision-makers, there should be a review by Enforcement Division lawyers who are not part of the investigation team.<sup>44</sup>

#### Expected Effect of Recommendations

Greater confidence in the FSA on the part of regulated firms and individuals, encouragement of self-reporting, remedial action and co-operation will be facilitated by improved enforcement procedures.<sup>45</sup> There is a danger that firms and individuals may react by introducing over-elaborate procedures to protect themselves from any risk of being thought to have breached an FSA requirement where there are concerns about the FSA's enforcement process in terms of case selection, conduct of the investigation or the decision-making process itself.<sup>46</sup> The changes recommended by the Review will not only help reduce any such 'over-compliance' that may exist but consumers will also benefit in that the more judicious and well respected the enforcement process is, the more it may encourage better compliance by regulated firms and individuals without recourse to enforcement action.<sup>47</sup>

It is anticipated that more cases will be settled earlier as a result of the Review's recommendations which consequently should reduce costs and assist consumers, both in terms of securing redress earlier and sending clear reminders to firms about the standards which the FSA expects of them.<sup>48</sup> Where cases do proceed to the RDC, the net effect of these recommendations will be to add to the overall costs of the FSA's enforcement process hence making it lengthier.<sup>49</sup>

#### The Role of the External Auditor as an Enforcement Tool in the Regulatory Process.

According to statistics, the FSA uses the enforcement tool selectively and this is consistent with the fact that the FSA is not an enforcement-led regulator. Evidence also shows that the FSA has decided a majority of rule breaches by firms through supervisory tools rather than enforcement action.<sup>50</sup> The reason for the selective use of the enforcement tool can be attributed to the fact that it is a relatively expensive tool. As well as highlighting the importance of the FSA's reliance on work carried out by external auditors and the importance of verifying such work carried out by external auditors, the Legal and General Case<sup>51</sup> also contributed to the debate about the need for greater reliance on on-site supervision by the FSA. The case highlighted that the presence of an opinion from a skilled person – in particular one who works for the regulated firm and is also paid by that firm, should merely assist in informing the FSA's decision making and should not act as a substitute to relieve the FSA from reaching its own decisions.<sup>52</sup>

Comments relating to the use of skilled person reports, as defined under s166 of FSMA, were made as a result of seven responses to the Enforcement Process Review Report.<sup>53</sup>

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44 See 'Matters Beyond the Role and Operation of the RDC' , FSA Enforcement Review 19 May 2005 <<http://www.lovells.com/Lovells/MediaCentre/PressBriefings/FSA+ENFORCEMENT+REVIEW.htm>>

45 <[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)> p 63

46 *ibid*

47 *ibid*

48 *ibid*

49 *ibid*

50 *ibid* p 17

51 *Legal and General Assurance Society (L & G) v FSA*

52 See 'Drawing Conclusions From Skilled Person Reports' p 37 para 5.38

<[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)>

53 [http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf) at p 35



## The Reporting Accountant (Skilled Persons)

Section 166 of the Financial Services and Markets Act 2000 deals with the powers of the FSA to obtain a report by a skilled person (reporting accountant) to assist the FSA in performing its functions under FSMA 2000. Under sections 167 and 168 of the Financial Services and Markets Act 2000, the FSA also has the powers to appoint competent persons to carry out investigations. The differences between the roles of reporting accountants (now known as skilled persons) and competent persons are demonstrated by the bearer of the costs for work carried out by these persons. For work undertaken by skilled persons, the bank bears the cost directly whilst for work undertaken by competent persons, the FSA bears the cost.<sup>54</sup> The role of the reporting accountant has become so important that it will be incorporated into the entire regulated sector.<sup>55</sup> Even though skilled persons are usually approved by the FSA, the role is usually performed by auditors of the regulated firm.<sup>56</sup> This raises the question of independence since both roles of auditors of the regulated firm and skilled persons employed by the FSA (reporting accountants) are distinct roles which still overlap occasionally.<sup>57</sup>

The use of skilled persons' reports has been controversial and concerns have been expressed in relation to the FSA using a skilled person's report instead of devoting its own resources to investigating a matter.<sup>58</sup> As well as highlighting the importance of the FSA's reliance on work carried out by external auditors and the importance of verifying such work carried out by external auditors, the Legal and General Case<sup>59</sup> has also contributed to the debate about the need for greater reliance on on-site supervision by the FSA. The case highlighted that the presence of an opinion from a skilled person – in particular one who works for the regulated firm and is also paid by that firm, should merely assist in informing the FSA's decision making and should not act as a substitute to relieve the FSA from reaching its own decisions.<sup>60</sup> A more proactive approach which facilitates more on site work being carried out by supervisors was recommended. The skilled persons' reports is expected to inform the FSA's decision making and in cases where the reports are used, the FSA would be expected to supplement it with additional work if necessary.<sup>61</sup>

The normal relationship between the external auditor and the audited bank needs to be safeguarded.<sup>62</sup> If no other statutory requirements or contractual arrangements governing the external auditor's work exist, all information flows between the banking supervisor and the auditor are usually channelled through the bank except in exceptional circumstances.<sup>63</sup> As a result, the banking supervisor will request the bank to arrange to obtain the information it requires from the auditor and such information will be submitted to the supervisor through the bank.<sup>64</sup> In addition, the tasks that the banking supervisor requires of the external auditor need to be within the auditor's technical and practical competence.<sup>65</sup>

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54 See J Hitchins, M Hogg and D Mallett, *Banking : A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants) 295

55 D Singh, 'The Role of Third Parties in Banking Regulation and Supervision' (2003) 4 (3) *Journal of International Banking Regulation* 9

56 *ibid*

57 *ibid*

58 *ibid* p 135

59 *Legal and General Assurance Society (L & G) v FSA*

60 See 'Drawing Conclusions From Skilled Person Reports' p 37 para 5.38

<[http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf)>

61 D Singh, 'The Role of Third Parties in Banking Regulation and Supervision' *Journal of International Banking Regulation* Volume 4 No 3, 2003 at p 37

62 For this and other safeguards, see 'The Relationship between Banking Supervisors and Banks' External Auditors' Jan 2002 para 58 page 15, pages 15-17 <<http://www.bis.org/publ/bcbs87.pdf>> (last visited 11th July 2008)

63 *ibid*

64 *ibid*

65 *Ibid* para 61 page 16

Measures have been adopted by the FSA to safeguard against possibilities of a conflict of interest between the auditors of the regulated firm who are commissioned by the FSA as skilled persons but are paid by the regulated firm. Chapter 5 of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons. The use of skilled person reports requires compatibility with the circumstances envisaged by s166 of FSMA and with the further guidance set out in the Supervision and Enforcement manuals.<sup>66</sup> The FSA may nominate or approve the appointment of the auditor of a bank as a skilled person if it is cost effective to do so but also takes into account any conflicts the auditor may have in relation to the matter to be reported on. There are also defined and limited circumstances in which a firm can use skilled persons.<sup>67</sup> The increased use of on site supervision with external auditors paid for by the FSA, would however reduce the potential problems that could arise where the FSA uses auditors of regulated firms as skilled persons. Other provisions which should assist the FSA's enforcement process include statutory powers being conferred by sections 165-169 and section 284 of the FSMA. These deal with the right of approval or removal, and the right to commission an independent audit to help the banks in ensuring that external auditors with the required experience, resources and skills are appointed to perform their duties.<sup>68</sup>

### Skilled Person Reports

In addition to highlighting the importance of clarity about the nature and purpose of the report being commissioned, comments relating to the use of skilled person reports, as defined under s 166 of FSMA, also address whether the output may ultimately be used in enforcement procedures.<sup>69</sup> One response questioned whether it was appropriate to use s166 reports to outsource 'investigative' work effectively<sup>70</sup>.

It was recommended that there should be regular liaison meetings between the firm, skilled person and the FSA whilst work on a skilled person report was being carried out.<sup>71</sup> This was to help identify any material new information which might affect the future direction of the work, consistent with SUP 5.5.4G and if necessary, the firm's supervisor should involve the enforcement team at an early stage and agree with them what the appropriate response was to any change of circumstances.<sup>72</sup> This recommendation should also enable the FSA, in association with the firm and skilled person to decide on whether changes need to be made to the scope of the work, or whether the matter was one for FSA staff to investigate.<sup>73</sup>

The initial communication between the FSA and the firm which lead to the production of the scope of the skilled person report will cover the nature of the opinion which the skilled person will be required to give before conclusions are drawn from skilled person reports. However, the presence of an opinion from a skilled person does not relieve the FSA from reaching its own decision regarding a firm's

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66 [http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf) at p 36; The SUP5.3 and ENF2.3.11 sections of the FSA Handbook set out wide range of circumstances for which a skilled person report may be suitable and the use of such a report for investigative (i.e. information gathering) purposes is, in the FSA's view, clearly contemplated both by FSMA and its own guidance; *ibid*

67 According to chapter 5 of the Supervision Manual, the FSA stated that firms are to appoint skilled persons only for specific purposes; not to use them as a matter of routine; to use skilled persons only after having considered alternatives; to use skilled persons because of the added value to be gained due to their expertise or knowledge and not because of resource restraints; to take into account cost implications and to use the tool in a focused and proportionate way.

68 See E Huepkes p 10

69 [http://www.fsa.gov.uk/pubs/other/enf\\_process\\_review\\_report.pdf](http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf) at p 36

70 *ibid*

71 *ibid* p 37

72 *ibid*

73 *ibid*

compliance with a particular set of rules – even though such an opinion will contribute to the FSA’s own decision-making.<sup>74</sup>

Some other responses noted that, depending on who in the FSA has commissioned them, the approach to skilled person reports and the clarity of scope etc can vary considerably.<sup>75</sup> Observations have also been made that, in particular circumstances, reports are commissioned informally when use of the formal s166 power would be more appropriate.<sup>76</sup>

The FSA’s own internal procedures are designed to facilitate consistency of approach in the use of skilled person reports and this is demonstrated by specifically highlighting that if information is required which is best obtained through a skilled person report, then that route should be favoured over any other route.<sup>77</sup> This is so not only because of the control which s166 gives the FSA over the scope of the report, the FSA’s right of access to it and any underlying working papers but also because of the co-operation and disclosure requirements which are connected both to the firm and third parties.<sup>78</sup>

Concerns about inconsistent approaches being adopted by different parts of the FSA or any departures from the FSA’s stated policies are to be brought to the FSA’s attention - the relevant feedback mechanism being the annual meeting which the FSA intends to have with the main firms used for skilled person work.<sup>79</sup> In the process of serious concerns emerging that cannot wait for these meetings, they are to be brought to the relevant supervisor’s attention.<sup>80</sup>

Following the collapse of Barings, neither the Board of Banking Supervision Report nor the Andersen Review of Supervision considered a total overhaul in the Bank of England’s approach to supervision. The predominantly “off-site” nature of the supervision undertaken by the Bank was lauded by the Andersen Review as being flexible and able to influence banks by persuasion and not just the force of law or detailed rules.<sup>81</sup> The Treasury Committee however noted that it was partly due to the discretionary basis of the Bank’s approach to supervision that there was limitation in its ability to detect events at Barings and that some of the measures proposed in the Bank’s review would help reduce the scope for flexibility.<sup>82</sup> According to the Bank’s Review of Supervision,<sup>83</sup> the Arthur Andersen Review (supported by the Bank’s Review of Supervision) suggests that the use of formal risk assessment models will mean that there is need “to bring the line supervisors into direct contact, on site, with a wider range of management.”

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74        *ibid* p 37; In some cases a skilled person report will be used to assess whether or not compensation is due to a class of customer (who may have been mis-sold a particular product) or whether the amount of compensation has been properly calculated and in such cases, the FSA would expect to be able to rely on the contents of the report, or where necessary, supplement it with additional work of its own; *ibid*

75        *ibid*

76        *ibid*

77        *ibid* p 38

78        *ibid*

79        *ibid*

80        *ibid*

81        Treasury Committee *Barings Bank and International Regulation* (Report No 1, 1996) xiv

82        *ibid*

83        July 1996 para 14