THE DEPUTY LEADER OF THE HOUSE OF LORDS

The Lord Sikka
House of Lords
SW1A 0PW

1 April 2021

Dear Lord Sikka,

I am writing in response to the points that you raised in the Grand Committee debate on the Financial Services Bill on 8 March, regarding the relationship between financial statements and prudential regulation. I apologise for the delay in writing to you.

The Prudential Regulation Authority (PRA) draws on a wide range of sources of information to fulfil its objectives. Although financial statements are one source of that information, they are not the primary source, so it is not necessary for financial statements to be capable of being used for prudential regulation.

The primary sources of information used by the PRA are the regulatory returns and other information it collects from firms (such as stress test information). Some of the numbers in the regulatory returns are lifted from firms' accounting balance sheets without amendment, but many are adjusted accounting numbers. Some are regulatory alternatives to the accounting numbers, and some have no accounting equivalent.

These adjustments and alternatives are necessary because the focus and purpose of regulatory returns are different to those of audited financial statements. For example, the focus of the solvency regulatory returns is on the nature and extent of loss absorbency. Therefore, numbers from the financial statements are used without adjustment in those returns only if and to the extent that they have been judged to be effective in showing those aspects of loss absorbency.

Similarly, the liquidity regulatory returns focus on particular liquidity attributes. The fact that there are differences between the regulatory framework and financial statements does not make one more valid than the other – they are each tailored to their own purpose.

Although the opinion expressed by the statutory auditor on the financial statements is of importance to the PRA – and the PRA might therefore wish to discuss aspects of those financial statements with the statutory auditor – it is also interested in several other issues. These include any insights or colour the statutory auditor may be able to provide on risk management, systems controls, and governance.

The International Financial Reporting Standards (IFRS) standards are designed to bring consistency to financial statements and are widely recognised by investors who value the transparency afforded by company reporting and the ability to compare the financial statements of companies around the world. The aim of statements prepared under IFRS is to provide a true and fair view of the assets, liabilities, financial position and profit or loss of the reporting entity, thereby allowing investors to make informed investment decisions. The comparability of financial statements afforded by IFRS has led to improved cross-border information, which allows for more informed and efficient international investments – because investors can more easily compare firms across different jurisdictions.

However, as I set out in Committee, banks are required to produce Pillar 3 reports, which contain a subset of the information used by the PRA to inform prudential regulation. Therefore, if investors do wish to factor prudential regulatory information into their investment decisions, the information needed is already available to them.

I hope you found this letter helpful. I am copying it to all those who spoke in the debate on 8 March, and I am placing a copy in the Library.

Yours sincerely,

EARL HOWE

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