National Audit Office

Overview

Financial services: regulation, redress and advice overview 2014

FEBRUARY 2015

Our vision is to help the nation spend wisely.

Our public audit perspective helps Parliament hold government to account and improve public services.

The National Audit Office scrutinises public spending for Parliament and is independent of government. The Comptroller and Auditor General (C&AG), Sir Amyas Morse KCB, is an Officer of the House of Commons and leads the NAO, which employs some 820 employees. The C&AG certifies the accounts of all government departments and many other public sector bodies. He has statutory authority to examine and report to Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively, and with economy. Our studies evaluate the value for money of public spending, nationally and locally. Our recommendations and reports on good practice help government improve public services, and our work led to audited savings of £1.1 billion in 2013.

Contents

Introduction

Aim and scope of this briefing

1 The Financial Services Act 2012 amended the Financial Services and Markets Act 2000 to make the Comptroller and Auditor General the statutory auditor of the Financial Conduct Authority, Prudential Regulation Authority, Financial Services Compensation Scheme, the Financial Ombudsman Service and Money Advice Service from 1 April 2013.

2 This overview gives a summary of the activities and performance of the 5 financial services regulation, redress and advice bodies. It is based on published sources, including each body's own annual report and accounts for 2013-14 and the work of the National Audit Office (NAO).

3 Part One focuses on each body's activity over the past year. Part Two examines how the organisations interact and cooperate. Part Three concentrates on our analyses of activity over the last year and challenges facing the individual bodies. Part Four contains case studies: the impact that the financial crisis had on the Financial Services Compensation Scheme; and the effect that the rise of payment protection insurance (PPI) mis-selling cases had on the Financial Ombudsman Service.

4 We have shared the content of this overview with each of the organisations to ensure that the evidence it presents is factually accurate.

Part One

The 5 financial services regulation, redress and advice bodies

1.1 The 5 bodies in this overview have a range of functions, but all are in some way responsible for maintaining financial stability and creating the conditions for a financial services sector that functions effectively. This part of our overview focuses on each body's activity over the past year.

1.2 Each of these bodies is independent of government. They have the power to carry out statutory functions in accordance with the relevant authorising and governing legislation. Each is described below.

Financial Conduct Authority (FCA)

The Financial Services Act 2012 created the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). These replaced the Financial Services Authority (FSA) from April 2013. The FCA is responsible for conduct regulation, as well as prudential regulation of firms not covered by the PRA. Conduct regulation aims to protect consumers from unfair practices from financial services providers. Prudential regulation aims to protect consumers and taxpayers from risks to the stability of the financial system. The FCA supervises the conduct of approximately 72,000 firms. This includes almost 50,000 firms supervised under the new consumer credit regime. The responsibility for regulating consumer credit, transferred to the FCA on 1 April 2014. The FCA also has an operational objective to promote effective competition in the interests of consumers.

Prudential Regulation Authority (PRA)

The PRA is a wholly owned subsidiary of the Bank of England. It is responsible for the prudential regulation of 1,700 banks, building societies, insurers, credit unions and major investment firms. The PRA's two statutory objectives are to promote the safety and soundness of these firms and, specifically for insurers, to contribute to the securing of an appropriate degree of protection for policyholders.

In promoting safety and soundness, the PRA focuses primarily on the harm that firms can cause to the stability of the UK financial system. A stable financial system is one in which firms continue to provide critical financial services – a precondition for a healthy and successful economy.

The PRA makes forward-looking judgements on the risks posed by firms to its statutory objectives. Those institutions and issues which pose the greatest risk to the stability of the financial system are the focus of its work.

Financial Services Compensation Scheme (FSCS)

The FSCS exists to pay compensation to consumers of financial services if a regulated firm fails. It also acts as a force for financial stability by reassuring customers that their deposits, insurance and investments are safe, up to the limits of protection offered by the scheme, and by paying compensation quickly when firms do fail. It is operationally independent but acts within the rules set by the PRA and FCA.

Financial Ombudsman Service (the Ombudsman)

The Ombudsman provides a dispute resolution service that is an alternative to the courts, to address complaints from consumers about businesses providing financial services. It was established by Parliament in 2001 as an amalgamation of ombudsman schemes in different parts of the financial services sector. It provides a free service to consumers. It has expanded significantly in recent years in response to mis-selling scandals, most notably because of payment protection insurance (PPI).

Money Advice Service (MAS)

The Money Advice Service was set up in 2010 with two main objectives: to enhance the public's understanding and knowledge about financial matters; and to improve the public's ability to manage their own financial affairs. It gives consumers free, independent, impartial information about money matters. Since April 2012, MAS has also funded debt advice, with responsibility for improving the availability, quality and consistency of debt advice services. This information is provided through a website, web-chat, phone and face-to-face sessions. It does not give advice that is regulated by the FCA.

How the bodies are funded

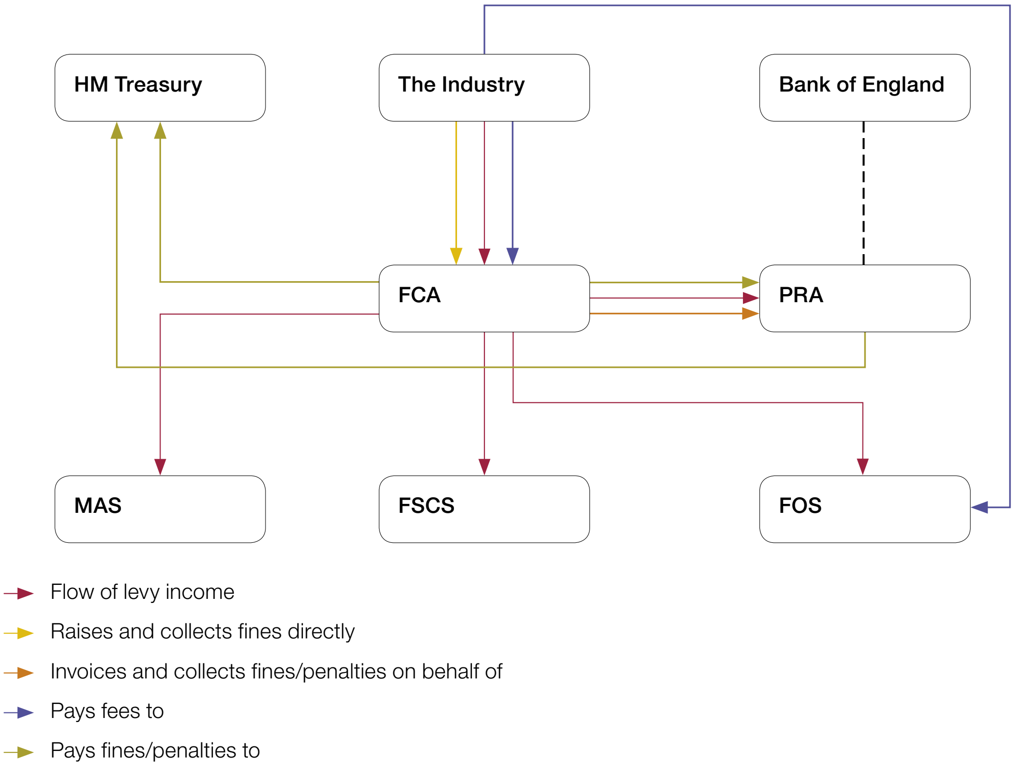
1.3 The 5 bodies are funded by levies on the financial services industry (the industry). For some of the bodies, these levies are supplemented by fees and penalties charged to specific firms. Levies are billed, collected and distributed by the FCA on behalf of the other 4. This process is illustrated in **Figure 1**. Part Two of this overview gives further details of how the 5 bodies interact.

1.4 **Figure 2** on page 8 shows levies and fee income raised for each of the 5 bodies in 2013-14, half of which related to FSCS. The majority of this was raised to repay the interest and principal on the major banking failure loans that HM Treasury made at the height of the 2008-09 banking failures. The impact of the financial crisis on FSCS is further explored in Part Four.

1.5 As well as collecting levies, the PRA and FCA can fine the financial services industry where they identify and prove wrongdoing.

Figure 1

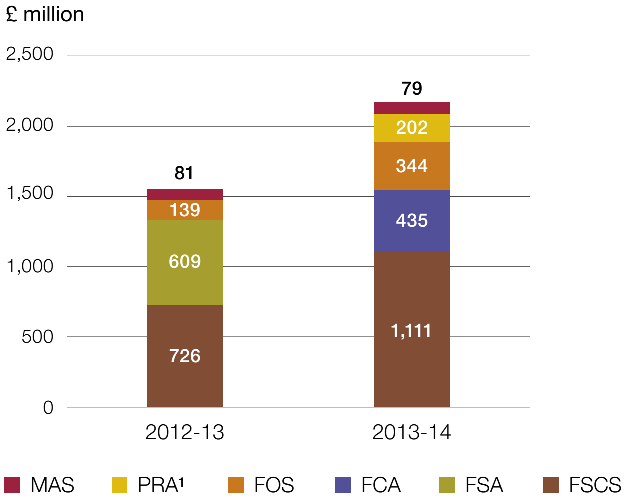
How the 5 financial services regulation, redress and advice bodies are funded



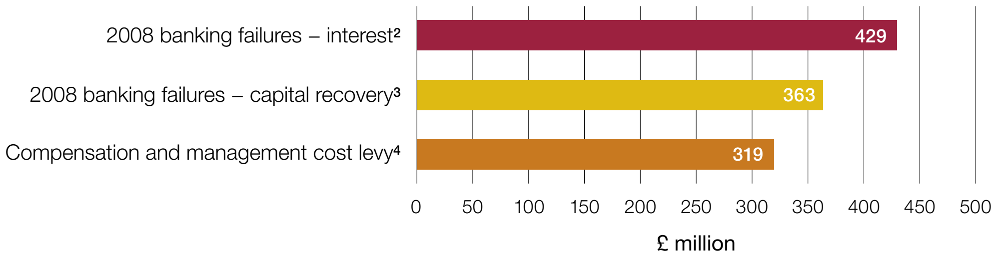
Source: National Audit Office

1.6 The Financial Services Act 2012 changed the rules on what happens to penalties charged to financial services firms. From 1 April 2012, any penalty receipts less relevant enforcement costs are paid to HM Treasury. Previously, legislation required the FSA to use fines for the benefit of authorised persons. Under the FSA penalty scheme, this meant that fines were used to effectively reduce the amount of levy paid by firms the following year, although the reduction was not applied to the firms that generated the fine. Consequently, firms no longer receive a discount on their fees from fines except so far as enforcement costs are covered.

Figure 2
Levy and fee income



FSCS levy income 2013-14



Notes

1 The PRA became operational on 1 April 2013, and produces accounts to 28 February each year. The PRA incurred start up costs in 2012-13 which are being recovered through future levies.

2 This is the interest payable to HM Treasury on the loans owed by FSCS. It is payable annually, funded by an industry levy.

3 The capital recovery levy is being collected from the industry because FSCS is unable to fully recover the legacy costs of the 2008 banking failures from the failed firms. It must therefore raise levies to repay HM Treasury loans.

4 Compensation and management costs levy is raised from the industry each year based on what FSCS predicts the level of compensation will be over the next 12 months. It can be increased by supplementary levies if necessary.

Source: Published annual reports and accounts 2013-14

1.7 **Figure 3** shows fines collected by the FCA, and the FSA before it, over the last 8 years. In 2012-13, it collected over £300 million fines for London Interbank Offered Rate (LIBOR) and Euro Interbank Offered Rate (EURIBOR) manipulation by UBS, Royal Bank of Scotland and Barclays. This higher level of penalties was sustained in 2013-14, although the reasons were more varied. These included a combination of LIBOR manipulation, mis-selling and control failings.

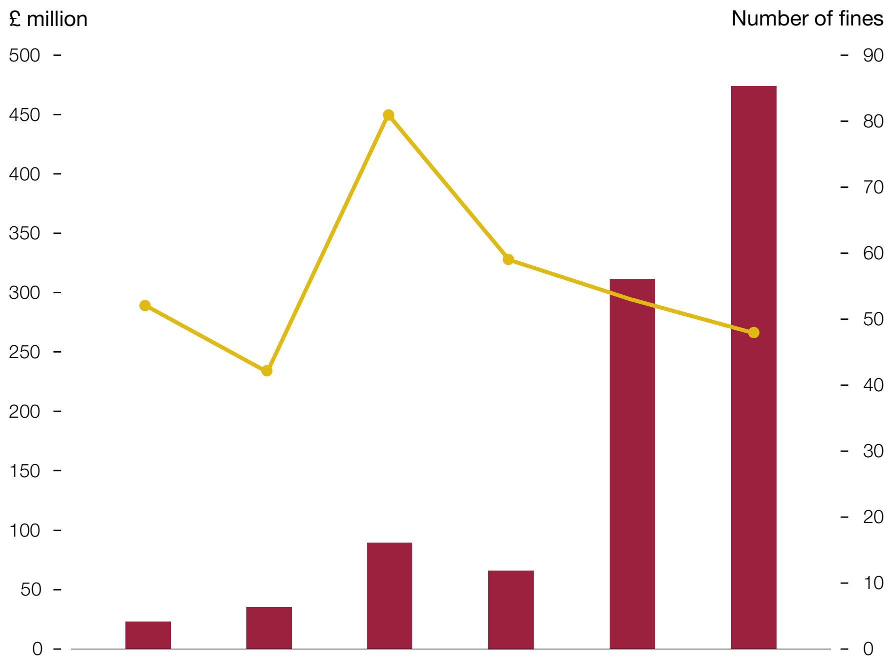
Administration and staff costs

1.8 Each of the bodies has different operational objectives and therefore employs different operational models. For example, while both the Ombudsman and FSCS deal with significant amounts of casework, FSCS outsources 89% of claims processing, whereas the Ombudsman carries out most operations in-house.

1.9 MAS has relatively low staff costs because most contact with the service is made through its website. This means its activities are not as resource intensive as the other bodies' operations.

Figure 3

Total value and number of fines imposed, 2008 to 2013



	2008	2009	2010	2011	2012	2013
Value of fines (£m)	22.7	35.0	89.2	66.1	311.6	474.2
Number of fines	52.0	42.0	81.0	59.0	53.0	48.0

Source: The Financial Conduct Authority website (www.fca.org.uk/firms/being-regulated/enforcement/fines/2013) and The Financial Service Authority website (www.fsa.gov.uk/about/press/facts/fines)

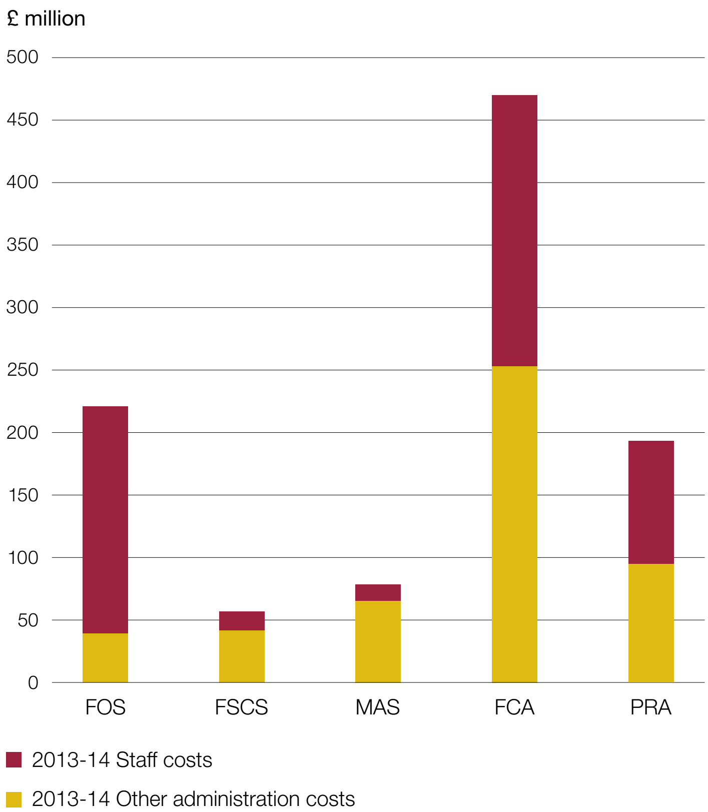
1.10 **Figure 4** shows total spending on administration for each of the bodies in 2013-14. Staff costs are identified separately. We have taken the figures from the administrative expenses notes published in each of the 2013-14 financial statements.

1.11 Figure 4 shows that one of the key drivers of cost is staff. The 5 bodies combined employed an average of 7,228 staff in 2013-14. **Figure 5** shows average staffing levels and turnover in each of the bodies in 2013-14. The combined average number of staff for the FCA and PRA in 2013-14 was 3,549. This was slightly fewer than the 3,596 that the FSA reported in 2012-13 before it was restructured.[1]

1.12 Figure 5 also shows the significant rise in staff numbers at the Ombudsman as caseloads continue to increase and become more complex. More detail on the expansion of the Ombudsman in relation to the PPI mis-selling scandal is in the case study in Part Four.

Figure 4

Staff costs as a proportion of total administrative expenditure, 2013-14



Source: Published annual reports and accounts 2013-14

1 Average staff numbers from published annual reports and accounts 2012-13 (Financial Services Authority) and 2013-14 (Financial Conduct Authority and The Prudential Regulation Authority).

Figure 5
Staff numbers and turnover

Organisation	Average FTE in 2012-13	Average FTE in 2013-14	Staff turnover in 2013-14 (%)
FCA	–	2,511	10.8
PRA	–	1,038	11.6
FSA	3,596	–	–
FSCS	179	192	12.4
FOS	2,288	3,389	10
MAS	76	97	19.4

Source: Published financial statements and National Audit Office analysis

1.13 Both the FCA's and PRA's annual reports highlight the high rate of staff turnover during 2013-14 as a concern. High turnover may have a negative effect on how effectively the bodies cooperate as relationships between former colleagues diminish as staff leave.[2] However, Figure 5 shows that, in fact, their level of staff turnover is consistent with FSCS and the Ombudsman (the Ombudsman's turnover figure is distorted by the scale of recruitment that occurred in during 2013-14 and which artificially depressed staff turnover). MAS has a higher level of turnover than the other bodies, although this was just after a period of organisational change.

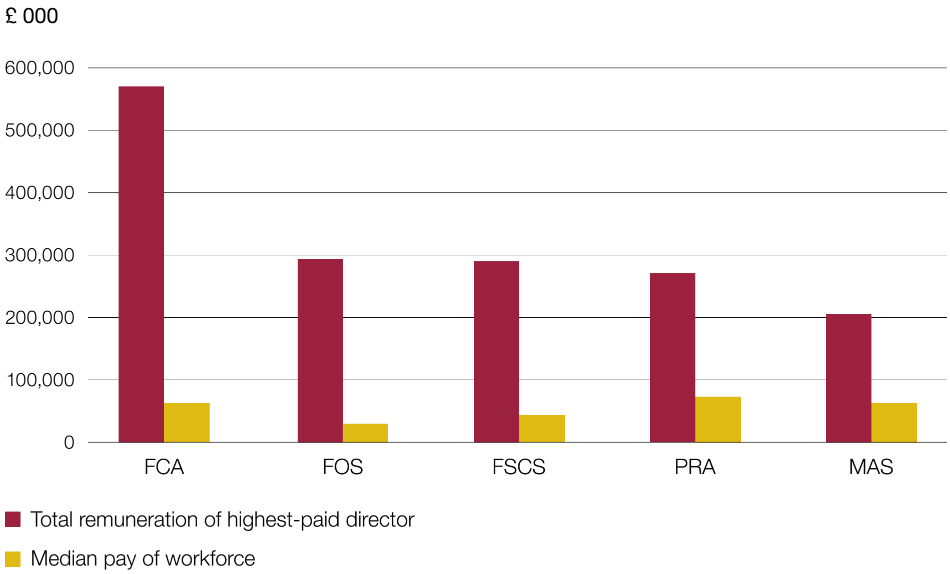
1.14 In 2013-14, all 5 bodies provided information on the remuneration of their senior management. This was in the form of a published remuneration report as part of their annual reports. The bodies have also published the pay ratio between the highest-paid director and the median full-time equivalent pay of the total workforce at the reporting period end date expressed as a multiple.

1.15 **Figure 6** overleaf shows both the highest-paid director and pay ratio of each of the bodies. It illustrates that there is wide variation in remuneration at the most senior level and within the pay ratio. However this reflects the diversity of size and function between the bodies.

2 Comptroller and Auditor General, *Regulating financial services*, Session 2013-14, HC 1072, National Audit Office, March 2014

Figure 6
Highest-paid director, 2013-14

Organisation	Total remuneration of highest-paid director	Median pay of workforce	Remuneration ratio
FCA	569,123	63,199	9.0
FOS	293,406	30,040	9.77
FSCS	290,463	43,449	6.7
PRA	270,165	73,448	3.68
MAS	205,000	63,000	3.2



Source: Published annual reports and accounts 2013-14

Transparency in financial reporting

1.16 The Financial Services Act 2012 amended the Financial Services and Markets Act 2000 to appoint the Comptroller and Auditor General as the external auditor of the 5 bodies. It also enabled HM Treasury to direct what the bodies must disclose in their annual report and accounts above and beyond the requirements of the Companies Act 2006. **Figure 7** sets out the reporting requirements of HM Treasury's Accounts Direction for each of the 5 bodies. In some cases, the bodies made the disclosures early or voluntarily even though they were not required to. HM Treasury is likely to add extra disclosures in 2014-15, for example special severance payments and losses and special payments.

1.17 We noted some good examples of transparency in financial and performance reporting during our audits of the annual reports and accounts.

1.18 The FCA's annual report is structured around its 3 operational objectives. It gives information on the progress it has made against each of them. This gives the report a coherent structure that is easy to understand. It enables the reader to see how the FCA has applied its resources to fulfil its statutory functions. There are also sections on challenges, which cover how the FCA is preparing to take on regulation of consumer credit and engage with international policy development. The report makes good use of graphics and case studies to present the information in an engaging way and increase its impact.

Figure 7

Parliamentary reporting 2013-14

	FCA	PRA	FOS	FSCS	MAS
Remuneration report	✔	✔	✔	✔	✔
Exit packages	✔	✔	✔	✔	✔
Special severance payments				✔	✔
Fair pay disclosures	✔	✔	✔	✔	✔
Balances with other government bodies	✔	✔	✔		✔
Losses and special payments					✔

Note

1 Blank cells indicate that HM Treasury does not require bodies to disclose this in 2013-14.

Source: *HM Treasury, Accounts Directions 2013-14*

1.19 The PRA has a useful breakdown of spending in the financial review section of its annual report. Spending is analysed by function so the reader can understand what type of activity the levy is spent on, for example supervising banking or insurance, or policy and regulatory activities. The same spending is then also displayed graphically showing the proportion spent on staff, property and IT, for example.

1.20 FSCS chose to prepare its 2013-14 financial statements in accordance with International Financial Reporting Standards (IFRS) for the first time. This aimed to enhance the quality of the financial information, make the financial statements more comparable and improve transparency for stakeholders. As part of the transition to IFRS, the FSCS directors took the opportunity to reassess the basis of preparation of the financial statements. This resulted in some significant transactions and balances being brought into the scheme manager accounts that had previously been reported only in the classes accounts. This further enhances transparency of the accounts for stakeholders.

1.21 The Ombudsman reports 'unit costs' of activity over time. These are calculated by dividing total running costs by total number of cases resolved in the year. This simple, but useful, metric helps the annual report's readers see how well the organisation is providing value over time. It is accompanied by meaningful explanations of fluctuations in unit costs. However, movements in unit costs may reflect changes in mix (type and complexity) of cases, behaviour of financial services firms, claims management companies and consumers, and the underlying efficiency of the Ombudsman's operations.

1.22 MAS's annual report has a section setting out its key performance indicators (KPIs) and whether these have been met during the year. This includes internal KPIs relating to the number of customer contacts achieved within the annual resource constraints as well as customer satisfaction feedback. Measuring outputs and outcomes will be easier for MAS than some of the other bodies included in this overview. Nonetheless, we recognise it is good practice to combine financial and performance reporting as far as possible to give a complete view of how effective the organisation has been during the year.

Part Two

Interaction and cooperation between the 5 bodies

2.1 This part of our overview examines how well the 5 organisations interact and cooperate.

Governance

2.2 Each of the bodies is a company limited by guarantee, except the Prudential Regulation Authority (PRA) which is limited by shares and wholly owned by the Bank of England. Each has an independent board, although there is significant interaction in the governance arrangements in place between the organisations, the Bank of England and HM Treasury.

2.3 HM Treasury appoints the Financial Conduct Authority's (FCA's) directors. The Board of the PRA comprises senior executives of the Bank ex officio, the FCA CEO, plus a number of other directors, appointed by the Bank with the approval of the Treasury. The FCA and the PRA have the right to appoint and remove the directors of the Financial Services Compensation Scheme (FSCS), Financial Ombudsman Service (the Ombudsman) and Money Advice Service (MAS). However, the appointed directors of each body have to exercise independent judgement in accordance with the Companies Act 2006 and therefore remain operationally independent.

2.4 The FCA has a memorandum of understanding (MoU) in place with the Bank of England and the PRA. This aims to ensure coordinated oversight of the markets and infrastructures for which the FCA or the Bank of England has supervisory responsibility.

2.5 Under the Financial Services and Markets Act 2000, the FCA is required to take such steps as are necessary to ensure that the Ombudsman and MAS are, at all times, capable of exercising their statutory functions. Similarly, the FCA and PRA are jointly responsible, under the same Act, for ensuring that the FSCS is capable of discharging its functions.

PRA and FCA collaboration

2.6 To fulfil their functions, it is very important that the PRA and FCA collaborate effectively. There are many areas where their work overlaps and they are legally required by the legislation to coordinate their activities effectively.

2.7 The FCA has a specific Memorandum of Understanding with the PRA which covers how it carries out its responsibilities and supports its commitment to working in an independent but coordinated way. The PRA can veto any FCA action that it considers may threaten financial stability, or cause the failure of a PRA-authorised firm in a way that would adversely affect financial stability. The PRA had not used this veto to date.

2.8 The PRA and FCA have set up a policy liaison committee to ensure they have a joined-up approach to making policy. They also have a joint data management committee to oversee how they share information and to coordinate how they collect data from firms. Both the PRA and FCA are represented on the Financial Policy Committee (FPC). These interactions are supplemented by regular meetings at various levels between the FCA and PRA.

2.9 Several joint working teams have been set up to deliver individual areas of policy and potential enforcement cases where there are common interests. For firms that are regulated by both regulators, the PRA assumes a lead role and manages a single administrative process for firms. The PRA consults with the FCA and either obtains consent to authorise a firm or considers any objections.

2.10 In March 2014, we published a report on the reorganisation of financial services regulation.[3] The findings of this are summarised on pages 19 and 20.

Resolution

2.11 FSCS is the UK's statutory fund of last resort for customers of financial services firms that have failed and cannot, or expect to be unable to, pay claims against them. FSCS's rules are set out in the FCA and the PRA handbooks. The FCA hosts the Financial Services Register of authorised firms. The PRA makes the compensation rules for deposit takers and insurers and the FCA makes the rules for other sectors.

2.12 The FCA shares information on industry trends and, where appropriate, intelligence and insights that it gains through supervisory work with the FSCS and the Ombudsman (the Ombudsman also has a duty to share information on industry trends and emerging issues with the FCA). The FCA alerts the FSCS to the risk of firms failing so it can prepare for the possibility that compensation may be payable. FSCS aims to pay compensation quickly so this intelligence is important in building the capacity to pay claims when a firm does fail.

3 Comptroller and Auditor General, *Regulating financial services*, Session 2013-14, HC 1072, National Audit Office, March 2014.

2.13 The Bank of England is the United Kingdom's resolution authority for banks, building societies, central counterparties and certain investment firms. Resolution is the process by which the authorities can intervene to manage the failure of a firm. The PRA has worked with the Bank of England's resolution directorate and internationally with the Financial Stability Board to develop credible resolution strategies for the global systemically important banks. FSCS and the PRA share information and exchange views on the resolvability of various financial services firms across the different sectors in the event of a failure.

Levy setting, billing, collection and distribution

2.14 The FCA raises and collects levies for all 5 bodies. This means firms can see their total regulatory costs in one place. Service level agreements (SLAs) in place with the other bodies set out these arrangements and the fees that each will pay the FCA for providing the service. The proportion of levy paid by each regulated financial services firm is determined by tariff data that firms submit to the FCA. The FCA performs checks on these data periodically to ensure they are accurate.

2.15 The total levies required are calculated by the PRA, FSCS, the Ombudsman and MAS. They are then submitted to the FCA, which raises invoices, collects and distributes the levies back to each body in line with the SLAs in place.

2.16 During the year, MAS carried out consultations with the FCA on the 2014-15 annual business plan and budget. The FCA's board approved the plan and budget at its meeting in March 2014. It also carried out consultations with HM Treasury, the Department for Business, Innovation & Skills, the FCA Smaller Business Practitioner Panel, the FCA Practitioner Panel, and the Financial Services Consumer Panel. The Ombudsman consults on the annual plan and budget, which is subject to approval by the board. It must then be authorised by the FCA.

2.17 FSCS is subject to a management expenses levy limit (MELL). The FCA and PRA set this each year after consultation. The MELL limits the amount FSCS can incur in management costs each year. The MELL no longer covers the interest costs on the loans that HM Treasury made to FSCS to meet the costs of compensating depositors following the major banking failures of 2008-09, as this is now levied separately.

Part Three

Our recent findings and future challenges

Annual reports and accounts

3.1 We audit the financial statements of government departments and associated bodies to allow the Comptroller and Auditor General (C&AG) to form an opinion of the truth and fairness of the accounts. In the course of these audits, we learn a great deal about bodies' financial management. Sometimes this can lead to further targeted work to examine particular issues. In this part of our overview, we look at the outcome of our most recent financial audit of the 5 financial services regulation, redress and advice bodies.

3.2 The financial year 2013-14 was the first in which the C&AG audited each of the 5 bodies under statute on behalf of Parliament. We have audited the Financial Services Authority (FSA) since 2010-11 and the Money Advice Service (MAS) since 2011-12, by agreement of their respective boards and the C&AG. The C&AG gave an unqualified opinion on each of the 5 bodies' 2013-14 financial statements.

3.3 As outlined in Part One, the Financial Service Compensation Scheme (FSCS) decided to adopt the International Financial Reporting Standards (IFRS) for the first time in 2013-14. It also took a fresh look at how information is reported in its financial statements. This resulted in some significant transactions and balances being brought into the scheme manager accounts that had previously been reported only in the classes accounts.[4] This change improved transparency for readers.

3.4 The C&AG also issued an extended audit certificate to the FSCS. This included, for the first time, details of the materiality level that we used and how we calculated it.[5] It also included what we considered to be the key risks and how these were addressed. The extended certificate is a requirement of International Auditing Standard (ISA) 700, applying to entities that report their compliance with the Corporate Governance Code. FSCS is the only one of the 5 bodies to do so and is therefore the only body to receive an extended certificate.

4 The Classes accounts provide a breakdown of funds and liabilities for each FSCS funding class.
5 A matter is material if its omission or misstatement would reasonably influence the decisions of users of the financial statements.

3.5 The Financial Ombudsman Service (the Ombudsman) took the opportunity to revisit a key accounting policy on recognising income in relation to case fees. Given the uncertainty relating to the stage of completion of payment protection insurance (PPI) cases it adopted a policy of deferring supplementary case fees until it reached a point of certainty, which it considers to be the month that the case is closed. At this point, it recognises the full case fee. The new accounting policy reflects the different characteristics of the Ombudsman's revenue streams more accurately.

3.6 The FSA ceased operating on 31 March 2013. It was succeeded by the PRA and FCA. The PRA has been included in the Whole of Government Accounts (WGA) since 2012-13. Both the FCA and the Ombudsman will be included in the 2013-14 WGA onwards. The FSCS and MAS have been included within the WGA since 2012-13 through their consolidation in HM Treasury's resource accounts.

Value-for-money reports

3.7 We have published 3 value-for-money reports on the financial services sector in recent years, of which 2 were published during 2013-14. Of the 2, the first examined whether advice given by the MAS is achieving value for money. The second reviewed the impact of the FCA and PRA on financial services regulation. During 2011-12, the Ombudsman invited us to review how efficiently it handles financial services complaints. We have summarised the principal findings of these reports below.

Regulating financial services

3.8 Our report *Regulating financial services* examined the FCA's and PRA's progress in developing and implementing their regulatory approaches.[6]

3.9 We highlighted areas where the regulators' work overlaps. They are legally required to coordinate their activities effectively. The FCA is operationally independent of government but accountable to HM Treasury. The PRA is a legal subsidiary of the Bank of England, and is also accountable to HM Treasury.

3.10 Both regulators plan more judgement-based, forward-looking and proactive regulation compared with the FSA's approach. While the latter approach currently costs more, these increased costs are set in the context of the potential benefits from changing regulatory approaches by more effectively reducing harm to consumers and limiting future taxpayer liabilities resulting from financial crises.

3.11 These are still early days for the new regulators. The new system comes at a higher cost, which is borne directly by regulated firms and ultimately by customers of the financial services industry. Building on their work to date, the regulators will need to clearly link resource allocation to regulatory effectiveness. They will need to show how they will tackle the problem of attracting and retaining the right staff to make their more proactive approach work.

6 Comptroller and Auditor General, *Regulating financial services*, Session 2013-14, HC 1072, National Audit Office, March 2014.

3.12 Our report made a series of recommendations, including that the regulators should:

- develop more structured approaches to the evaluation of their work, refine performance measurement frameworks further and publish key measures of performance;
- effectively manage collaboration and potential conflicts between FCA and PRA – for example they should evaluate the impact of their new approaches to regulatory data requests and build a body of evidence from experience of managing potential conflicts between prudential and conduct regulation; and
- review the effect that staff turnover rates are having in practice – based on the levels of skills and experience the regulators want to retain, they ought to determine what an appropriate turnover rate is. The PRA and FCA are currently working to develop long-term strategies to attract and retain the best talent. They should ensure that the staff offer they choose reflects the target turnover rate.

Helping consumers manage their money

3.13 Our report *Helping consumers to manage their money* examined whether the advice services offered by MAS represent value for money for consumers.[7] MAS initially had two objectives, to enhance the public's:

- understanding and knowledge about financial matters; and
- ability to manage their own financial affairs.

3.14 MAS gives consumers free, independent, impartial information about money matters. It does not give advice that is regulated by the FCA (for example, advice on choosing financial products), so it is restricted in the information it can give. It gives this information (referred to as 'money advice' in this report) through its website and through web-chat, phone and face-to-face sessions.

3.15 Our report concluded that MAS has achieved value for money in its debt advice work. The number of advice sessions has increased and unit costs have fallen. The quality of advice has continuously improved since we last examined them in 2010. For the provision of money advice, MAS is only now moving in the right direction to allow it to add more value in providing an important service. It has not yet shown that it is achieving value for money. This is because, so far, it has not sufficiently targeted its advice at those who need it most. It is now moving in the right direction by developing a more specific and targeted service.

7 Comptroller and Auditor General, *Helping consumers to manage their money*, Session 2013-14, HC 879, National Audit Office, December 2013.

3.16 The government committed to reviewing MAS before the end of this Parliament. In May 2014, HM Treasury announced an independent review of MAS, which will:

- assess the need for consumer education and advice, including how this may evolve as, for example, individuals have greater freedom over their retirement options, and the role that MAS should play in the wider consumer education and advice landscape;
- assess how effectively and efficiently MAS is meeting this need through its current approach and delivery models; and
- recommend any changes to MAS's approach and delivery models that would enable it to better meet this need.

3.17 The review will be led by Christine Farnish, who has previously served as chief executive officer of the National Association of Pension Funds and as chairman of Consumer Futures. She will report to the Economic Secretary to the Treasury shortly.

Efficient handling of financial services complaints

3.18 Our report *Efficient handling of financial services complaints* was a forward-looking review of the Ombudsman at a time when it was undergoing significant change.[8] This was in response to a huge increase in demand for its services. In 2011, the Ombudsman's board invited us, acting on behalf of the C&AG, to review the efficiency of its operations.

3.19 Our report noted that there had been rapid growth in demand for the Ombudsman's services. In the 10 years since it had been established, the Ombudsman had changed considerably. It took on 206,121 cases in 2010-11: an increase of 376% on its 2001-02 caseload. As the service had grown, it had become possible, and necessary, to realise efficiencies of scale.

3.20 Volatile demand and mass claims represent significant efficiency challenges for the service. In recent years there has been an increase in mass claims relating to the mis-selling of particular types of products, notably mortgage endowment cases from 2004 and PPI from 2009. This has led to large surges in demand, which have presented significant operational challenges.

3.21 During this time, the Ombudsman experienced both a rise in its unit costs and an increase in the number of cases taking more than one year to resolve. We stated that the Ombudsman needed to achieve efficiencies of scale to deal with the highly volatile demand it will continue to face in the future. To do so, the Ombudsman needed to develop a more complete understanding of the factors that are driving its unit costs so that it can begin to tackle the causes of the increases it has experienced.

8 Comptroller and Auditor General, Financial Ombudsman Service, *Efficient handling of financial services complaints*, National Audit Office, January 2012.

3.22 The Ombudsman had recognised areas where it could improve its processes and be more responsive to the volatile demand for its services. It put in place an ambitious change programme that aimed to address many of the efficiency challenges it was facing. Delivering change on this scale is a major undertaking. We reported that the Ombudsman was managing the programme well and should be pleased with its progress to date. However, we recommended that it should strengthen some elements of its programme management arrangements, such as the monitoring of both benefits and unintended impacts of change, and budget control.

Achievements in 2013-14 and challenges

3.23 The 5 bodies have responded to significant challenges during the year. They are subject to considerable external pressures from domestic and international legislation, events in the markets and the behaviour of financial services firms and customers alike. **Figure 8** shows a summary of just a few of the key achievements and challenges each body has identified. These are taken from the annual report of each organisation.

Figure 8

Achievements in 2013-14 and challenges

Financial Conduct Authority[1]

Achievements

Conducted research that showed the majority of stakeholders are clear about FCA's objectives – a major achievement for a new regulator.

Transition from traditional regulation to a focus on conduct with firms now starting to look at the way they conduct business and treat consumers.

Introduced a new supervision model that includes proactive forward-looking work, reactive work and thematic reviews across firms.

FCA's commitment to intervene sooner was demonstrated by: interest-only mortgage customers being contacted by providers alerting them to dangers of not having a plan to repay the loan; building a broad range of relationships, reaching out to consumer groups and forging new ties with organisations to help us hear more directly from consumers; and by establishing a regulatory regime for the London Interbank Offered Rate (LIBOR).

Established a 'milestone' agreement with the UK's biggest banks to adopt a same-day 'retry' system to take payments. This has prevented millions of pounds of bank charges to customers.

Launched first market study into general insurance, bringing a new perspective through use of behavioural economics.

Was instrumental in constructing redress schemes for payment protection insurance, card protection and interest rate swap mis-selling, paying out millions of pounds in compensation.

Collected £425 million in financial penalties and secured 5 convictions in 2013-14.

Challenges

Implementing recommendations in the Financial Services (Banking Reform) Act 2013.

Impact of guidance on pensions in the budget (annuities reform).

Implementing European and international agendas.

Preparing for the launch of the new payments systems regulator on 1 April 2015.

Took over responsibility for regulating consumer credit from 1 April 2014, involving the transition of almost 50,000 firms into its regime.

Prudential Regulation Authority[2]

Achievements

The PRA's new approach to supervision is for supervisors to use judgement and be forward-looking. This has been demonstrated by:

- PRA, with the Financial Policy Committee, taking action to strengthen the balance sheets of major banks and building societies to support the economic recovery.
- Introducing a new annual stress testing regime for banks.
- Introduced 'One Bank' approach to derive synergies between the Bank of England and PRA.
- Helped design and implement European and international reforms to supervisory standards, eg Solvency II for insurers.
- For insurance companies, focused on building two new directorates: one for general insurance and one for life insurance.
- Introduced new recovery and resolution rules so it is better prepared if firms fail.

Future challenges

PRA working with Bank's Resolution Directorate – comprehensive plans to resolve major UK banks are being drawn up.

PRA does not operate a zero failure regime. Need to ensure firms are able to fail without threatening the stability of the system as a whole.

Resourcing was a significant challenge in 2013-14 with delays in recruitment and higher than expected turnover of staff.

Figure 8 *continued*
Achievements in 2013-14 and challenges

Financial Services Compensation Scheme[3]

Achievements

Effective partnership working – strengthened relationships with FCA, PRA, HM Treasury and the Bank of England through regular contact.

Contingency planning and sharing information about resolvability of various financial services firms across the different sectors.

Raising awareness – 60% of the public are aware of FSCS or a deposit protection scheme's existence. This is good but needs to increase.

Transparent relationships with levy payers – FSCS makes efforts to ensure the levy-setting process is transparent. It adopted a 3-year average levy model for all except the deposit-taking class. This ought to reduce the volatility of annual levies and the risk of interim levies being required.

90% compensation paid within 10 working days of acceptance of offer.

Significant commitment and contribution to international engagement via various bodies, such as International Association of deposit Insurers (IADI) and European Forum of Deposit Insurers (EFDI).

Future challenges

Raise awareness of protection across all products and services that FSCS covers, increasingly important in light of changes to pension rules announced in the budget 2014.

New responsibilities from the Financial Services (Banking Reform) Act 2013 to:

- operate FSCS efficiently and effectively and minimise public spending arising from the loans and other financial assistance; and
- provide HM Treasury with information for government accounting purposes.

Deal effectively with an increase in self-investing pension plan mis-selling cases.

Respond to and implement the European Union's Deposit Guarantee Schemes Directive (DGSD).

Invest in the Connect programme to enable consumers to make claims direct to FSCS via a secure online process.

Resolution of the Bradford & Bingley legacy loan following the transfer of protected deposits from B&B to Santander in September 2008. B&B is now managed by UK Asset Resolution in public ownership, with payment expected in 2024. Under the terms agreed, FSCS shall recover no less than if B&B had entered into liquidation and so there are challenges around this interpretation and seeking to achieve repayment from the company as soon as possible.

Financial Ombudsman Service[4]

Achievements

Huge rise in demand for the Ombudsman's services is an indication of wider awareness of the service: over 500,000 cases received in each of 2012-13 and 2013-14 (similar to the total for the previous decade).

PPI demand has again outstripped all expectations. However, the service has coped, which shows that organisational planning has been effective.

The Ombudsman has achieved recruitment – around 2,000 in the space of 18 months – and retention targets by investing in training and developing staff.

In 2013-14 the Ombudsman introduced a new funding framework for the 4 largest financial services groups. This provides a regular, stable income and increased efficiency through lower overheads.

The vast majority of cases are now handled electronically.

Future challenges

The Ombudsman is a demand-led service, so although it consults widely on plans and assumptions, forecasting and planning demand is very difficult.

There is a high degree of volatility in the types of cases referred to the Ombudsman so it has to be able to respond flexibly and effectively with whatever it is called on to do.

Outside PPI, there has been a significant increase in packaged bank accounts cases.

The Ombudsman recognises that timeliness is an area for improvement. It is looking for ways to streamline this further in future.

Figure 8 *continued*
Achievements in 2013-14 and challenges

Money Advice Service[5]

Achievements

During 2013-14, MAS has pursued new partnerships and deepened existing relationships to help reach many more people than would otherwise be possible.

Dealt successfully with more than 16 million customer contacts over the year – on average well over 40,000 every day.

People completed the budget planner nearly 300,000 times during the course of the year. The vast majority used MAS's online planning tools, helped by a number of refinements to make it even quicker and easier to use.

Set a target for 480,000 key outcomes over the year. These included people using the service to:

- help them save regularly;
- prepare for their retirement;
- protect their assets or their dependants against unexpected events; and
- take steps to manage their debt.

MAS exceeded this target by 35% by the end of the year.

Future challenges

The principal challenge is the size of the tasks to provide financial advice to everyone in the UK and the uncertainties relate to the fact that this has never been achieved before.

As well as its own service, 2013-14 was the second year MAS was responsible for coordinating the debt advice sector and for funding several key debt projects. With some 9 million over-indebted people in the UK, this is a hugely important part of MAS's work. Here the role of its partners is especially vital. MAS depends on partners across the UK to deliver the high standard of service people need.

Notes

1 Financial Conduct Authority, *Annual Report 2013/14*, HC 349, July 2014. Available at: www.fca.org.uk/static/documents/corporate/annual-report-13-14.pdf

2 Prudential Regulation Authority, *Annual Report and Accounts 2014*, HC 165, June 2014. Available at: www.bankofengland.co.uk/publications/Documents/annualreport/2014/prareport.pdf

3 Financial Services Compensation Scheme, *Annual Report and Accounts, 2013/14*, HC 487, July 2014. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/327838/FSCS_annual_report_2014_web.pdf

4 Financial Ombudsman Service, Directors, Report and financial statements, *Annual Report and Accounts*, 2013-14. Available at: www.financial-ombudsman.org.uk/publications/annual-reviews.htm

5 Money Advice Service *Annual Review, Directors' Report and Financial Statements*, 2013-14. Available at: www.moneyadviceservice.org.uk/en/static/publications#corporate

Source: Published 2013-14 Annual Report and Accounts

Part Four

Case studies

4.1 This part of our overview highlights two case studies where the Financial Services Compensation Scheme (FSCS) and Financial Ombudsman Service (the Ombudsman) have had to deal with an increase in the scale of their new activities that was not envisaged before the 2008 banking failures.

Legacy of the financial crisis for FSCS

4.2 As noted in its 2013-14 annual report, before the financial crisis the FSCS had a low profile.[9] This is because no-one had really expected major banks and financial services providers to fail on the scale seen during the crisis.

4.3 FSCS paid out £23 billion (including approximately £3 billion on behalf of HM Treasury) following the failures of 5 banks in 2008: Bradford & Bingley; Kaupthing Singer & Friedlander Limited; Heritable Bank Plc; Icesave; and London Scottish Bank Plc. To fund these payments, FSCS had to borrow from HM Treasury.

4.4 The continuing impact of the financial crisis on FSCS can be seen in **Figure 9**. This shows that fees levied on the industry in 2007-08, before the financial crisis, were £53 million. In 2013-14 they had risen to £1.1 billion – an increase of over 2,000%. A breakdown of the 2013-14 levy is given in Figure 2. By far the largest cost to FSCS was the resolution of Bradford and Bingley.

4.5 The largest element of the levy received in 2013-14 (£429 million) was to fund the interest payable to HM Treasury. The second largest element (£363 million) was to fund the expected capital shortfall in recovery from the administrations of these firms. The part of the levy raised to fund other compensation and FSCS's management costs was the smallest (£281 million).

4.6 **Figure 10** plots total levy income against total recovery income from the estates of failed firms over a 7-year period to 2013-14. This highlights the effect of the 2008 banking failures with FSCS forecasting significant recoveries in the medium to long term for these interventions (for example, £15,654 million from Bradford & Bingley). However the FSCS, as detailed in its annual plan and budget, is predicting a £1.161 million shortfall in capital recovery from the administrations of the failed firms, which will be met through levies on the industry.[10] The shortfall is largely attributable to Icesave and Dunfermline Building Society.

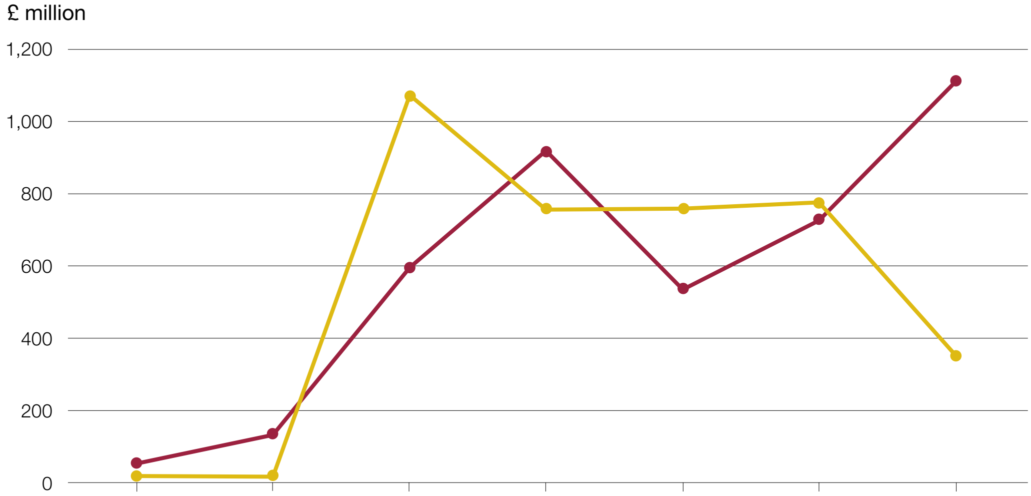
9 Financial Services Compensation Scheme, *Annual Report and Accounts*, 2013-14, HC 487, July 2014.
10 Financial Services Compensation Scheme, *Annual Plan and Budget: 2014-15*.

Figure 9
Impact of the global financial crisis on FSCS

	2007-08 (£m)	2008-09 (£m)	2009-10 (£m)	2010-11 (£m)	2011-12 (£m)	2012-13 (£m)	2013-14 (£m)
Levy income	53	132	596	919	535	726	1,111
Recovery income	19	17	1,073	756	759	776	352
Compensation paid out	83	92	605	535	346	325	243
Legacy loans issued related to 2008 banking failures	0	19,767	500	0	0	0	0

Source: Financial Services Compensation Scheme annual reports and accounts 2007-08 to 2013-14

Figure 10
Levy income and recovery income since the financial crisis



	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Levy income (£m)	53	132	596	919	535	726	1,111
Recovery income (£m)	19	17	1,073	756	759	776	352

Source: Financial Services Compensation Scheme annual reports and accounts 2007-08 to 2013-14

4.7 **Figure 11** shows total other compensation expenditure plotted against the interest expense on the loans payable to HM Treasury. This shows that as compensation costs fall back to more normal levels, the cost of servicing the finance provided by HM Treasury has begun to exceed total compensation expenditure.

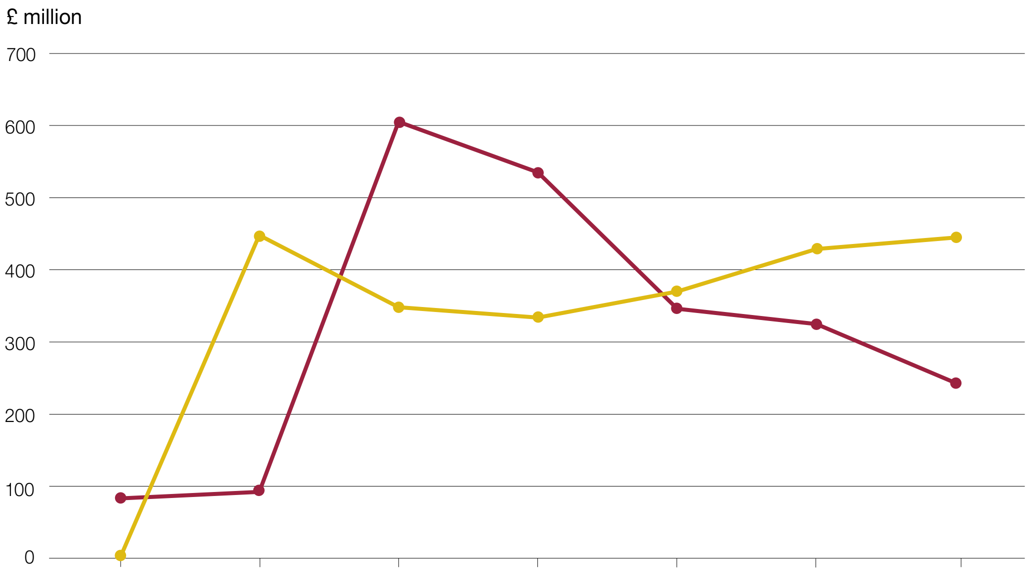
The effect of PPI mis-selling on the Ombudsman

4.8 The mis-selling of payment protection insurance (PPI) is one of the largest mis-selling scandals in history. The volume of claims referred to the Ombudsman has had a dramatic effect on its size and operations.

4.9 The difficulties in forecasting the level of PPI cases has resulted in the banks, the FCA, industry trade associations and the Ombudsman underestimating the number of complaints that would be received.

Figure 11

Compensation and loan interest payable to HM Treasury since the financial crisis



	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Compensation paid out (£m)	83	92	605	535	346	325	243
Loan interest payable to HM Treasury (£m)	–	448	348	334	370	429	445

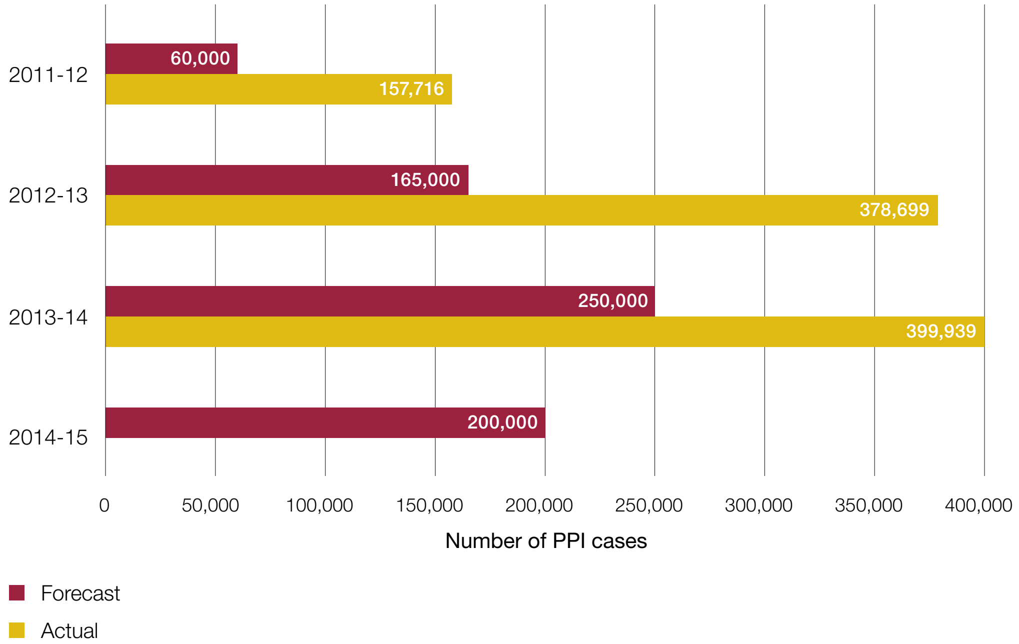
Source: Financial Services Compensation Scheme annual reports and accounts 2007-08 to 2013-14

4.10 Figure 12 shows the difficulty the Ombudsman has faced in accurately forecasting demand for PPI cases to be resolved in recent years. It has engaged with stakeholders and publicly consulted on demand assumptions, but PPI volumes have consistently exceeded estimates from the regulator, financial service firms, the Ombudsman, and other commentators.

4.11 Figure 13 overleaf shows the rapid increase in the number of new and resolved cases.

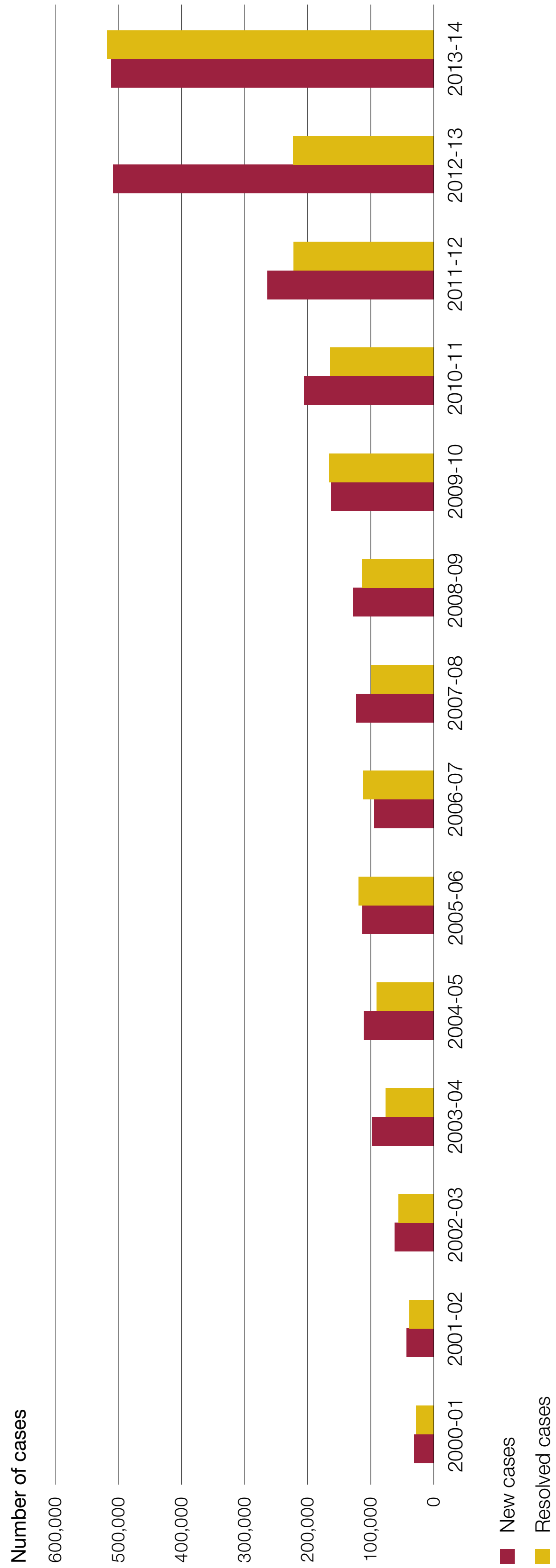
Figure 12

Volume of PPI cases received by the Ombudsman versus forecast



Source: The Ombudsman's analysis

Figure 13
New and resolved cases referred to the Ombudsman 2000-01 to 2013-14



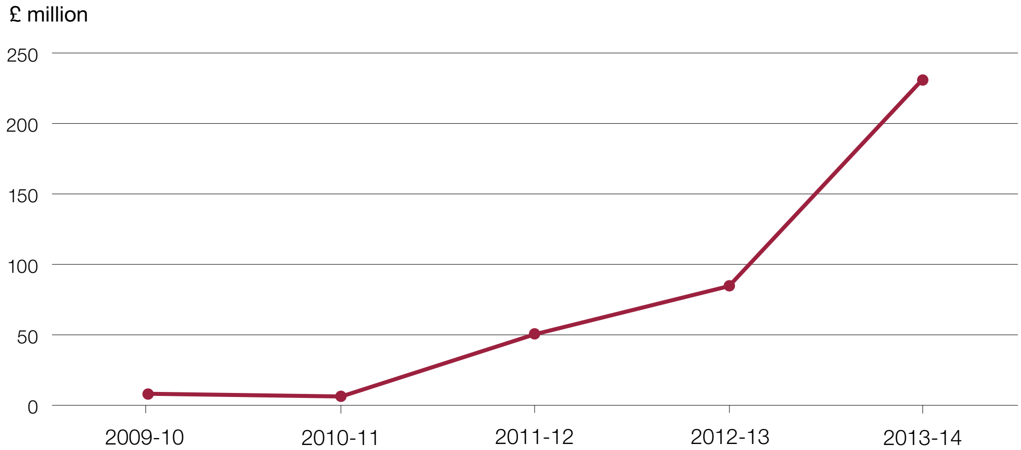
Source: Published Ombudsman financial statements

4.12 To help meet the whole-life costs of the PPI operation (including start-up and wind-down costs), the Ombudsman introduced a supplementary fee. The Ombudsman charges this fee when a case is passed to it; standard case fees are charged once a case is resolved. However, because the number of PPI complaints has been higher than expected, this greater workload has meant the Ombudsman has built up a higher level of reserves. At 31 March 2014, it had accumulated a significant bank balance of some £231 million. The trend of holding increasing levels of cash is shown in **Figure 14**. The Ombudsman has confirmed that, from 1 April 2014, it is no longer charging businesses a supplementary case fee for each PPI mis-selling complaint now that it has "has geared up resources sufficiently to tackle the unprecedented PPI workload".[11]

4.13 Figure 13 shows the huge increase in demand for the Ombudsman's services. Where FSCS outsources 95% of claims handling so it can increase or reduce in size in response to volatile demand, the Ombudsman predominately handles claims using in-house staff. The number of staff the Ombudsman employs has increased in line with the huge rise in claims (**Figure 15** overleaf). As the number of PPI claims peaks and begins to fall, the Ombudsman will need to have a plan for reducing staff if this becomes necessary.

Figure 14

Cash balances held by the Ombudsman over 5 years

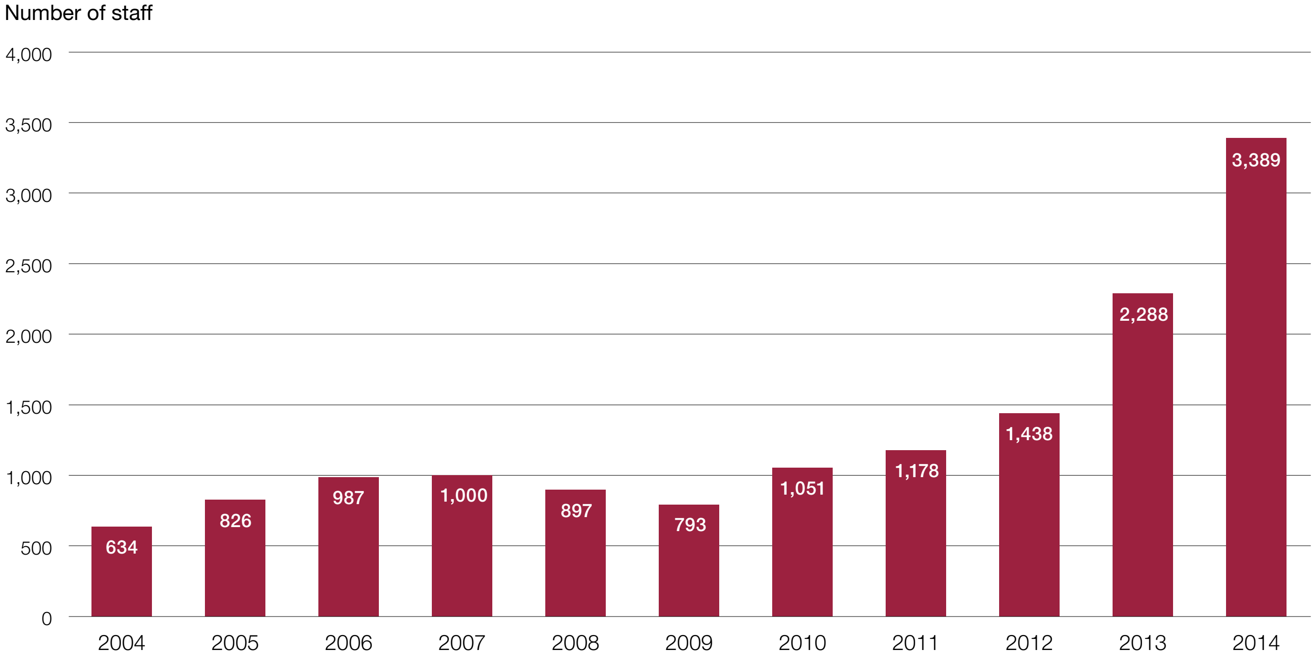


	2009-10	2010-11	2011-12	2012-13	2013-14
Cash balances	9	7	51	85	231

Source: Published Ombudsman financial statements

11 Financial Ombudsman Service, *Our plans for the year ahead*, March 2014. Available from: www.financial-ombudsman.org.uk/publications/plans-for-year-ahead-2014-15.pdf.

Figure 15
The Ombudsman's staffing levels 2004–2014



Source: Published Ombudsman financial statements

Where to find out more

The National Audit Office website is
www.nao.org.uk

If you would like to know more about the NAO's work on the financial services bodies in this report, please contact:

Steven Corbishley
Director
020 7798 7619
steven.corbishley@nao.gsi.gov.uk

If you are interested in the NAO's work and support for Parliament more widely, please contact:

Adrian Jenner
Director of Parliamentary Relations
020 7798 7461
adrian.jenner@nao.gsi.gov.uk

Twitter: @NAOorguk

National Audit Office

Design and Production by NAO Communications
DP Ref: 10649-001