



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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## **The Financial Conduct Authority and the Prudential Regulation Authority**

# Regulating financial services

## Key facts

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**£234.2bn**

estimated value of the UK  
financial services industry

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**3,815**

full-time equivalent employees  
at the PRA and FCA in  
December 2013

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**£664m**

forecast combined cost of the  
two regulators in 2013-14

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**£127 million** regulators' forecast increase in the cost of regulation between  
2012-13 under the Financial Services Authority and 2013-14  
under the Prudential Regulation Authority (PRA) and Financial  
Conduct Authority (FCA)

**26,000** firms whose conduct is regulated by the FCA

**23,000** firms prudentially regulated by the FCA

**1,700** firms prudentially regulated by the PRA

**£472 million** value of regulatory fines levied in 2013

**9.7 per cent** 2013 annualised staff turnover at the FCA

**11.7 per cent** 2013 annualised staff turnover at the PRA

# Summary

**1** The financial services industry is worth an estimated £234.2 billion and therefore plays a key role in the UK economy. Managing risks in financial services requires a range of regulatory interventions. Conduct regulation aims to protect consumers from unfair practices from providers. Prudential regulation aims to protect consumers and taxpayers from risks to the stability of the financial system.

**2** Following the financial crisis, the government decided to reform the regulatory system. The Financial Services Act 2012 created the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) to replace the Financial Services Authority (FSA) from April 2013.<sup>1</sup> The PRA undertakes prudential regulation of all banks, building societies, insurers and credit unions, and major investment firms. The FCA is responsible for conduct regulation, as well as prudential regulation of firms not covered by the PRA.

**3** There are numerous areas where the regulators' work overlaps, and they are legally required by the legislation 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. The Financial Policy Committee is established within the Bank of England to issue recommendations and directions to the regulators over matters of financial stability, and the PRA has the power of veto over the FCA in certain circumstances. The regulators also have to coordinate with other UK and international organisations with related responsibilities.

<sup>1</sup> As well as establishing the regulators, the Financial Services Act 2012 amended existing legislation including the Financial Services and Markets Act 2000 (FSMA), the Bank of England Act 1998 and the Banking Act 2009. Throughout this report we refer to legislative requirements collectively as 'the legislation'.

**4** The National Audit Office (NAO) was not the statutory auditor of the FSA. Under the Financial Services Act 2012 the NAO was made the statutory auditor of the FCA and the PRA from April 2013. This report examines the progress made by the FCA and the PRA in developing and implementing their regulatory approaches to date. Our statutory audit rights do not cover the wider Bank of England or the Financial Policy Committee.

## **Key findings**

### Costs

**5 The two new regulators cost more than the FSA did.** The regulators are funded from fees paid by regulated firms, and ultimately by customers of the financial services industry. Both regulators plan more judgement-based, forward-looking and proactive regulation compared to the FSA's approaches. While this 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. The regulators' forecast combined cost of their ongoing activities in 2013-14 is £664 million – £127 million (24 per cent) higher than the 2012-13 cost of the FSA. The regulators attribute the forecast increase mainly to changed approaches, particularly additional front-line staff, and additional costs to replace information technology (IT); and to the costs of running two regulators instead of one, with new IT, support and premises costs. In some years additional regulatory costs related to appointments of 'skilled persons' can be substantial (paragraphs 1.16 to 1.20, 2.3 and 4.4).

### Approaches to regulatory decisions

**6 The regulators have in most areas set out their objectives and strategic approaches clearly.** Each regulator has translated its statutory objectives into more specific and measurable operational objectives. The regulators' respective prudential and conduct objectives can by their nature conflict. The regulators currently manage this conflict through their existing coordination processes set out in a memorandum of understanding. The Chief Executives of the regulators meet quarterly to review how well coordination is working. However, they could build on these processes by specifically bringing together and sharing their experience of managing such potential conflicts (paragraphs 1.6 to 1.10, 1.11 and 4.7, and **Figure 2**).

**7 Some of the changes in strategic approaches are becoming evident at working level.** The regulators aim to adapt how they regulate in order to achieve more judgement-based, forward-looking regulation, through a combination of structural and functional changes, directing resources in line with their approaches and priorities, and actions aimed at instilling cultural and behavioural change among regulatory staff. Approaches to authorising firms and individuals have changed with dual regulation, and early evidence indicates some slowing of processing in dual-regulated cases, where the average time spent on new firm authorisations between April and December 2013 increased by three weeks, compared to processing under the FSA. There has been more substantial change in how regulators supervise firms, for example the FCA has separated firm-based supervision, 'event'-based supervision and thematic reviews in its internal organisation, and stakeholders we interviewed and surveyed welcomed the use of thematic reviews. Some stakeholders raised concerns about the volume and prioritisation of thematic reviews and coordination between firm-specific and thematic teams. The FSA made increasing use of fines for misconduct in its later years. In 2013 the value of regulatory fines levied on firms came to £472 million. It is too early to say whether the FCA has increased enforcement activities further. Feedback from working-level supervisors indicated that the changing approaches have had practical benefits in providing clearer separate focus and greater depth to prudential and conduct work, and encouraged earlier and more decisive regulatory intervention (paragraphs 2.3 to 2.10).

**8 Regulators have established decision-making structures and risk appetites but these present some challenges at working level.** Each regulator allocates more resources to firms posing greater risks to consumers or markets, based on its own assessment of those risks. Each regulator has developed a risk appetite and decision-making structures to help inform decisions about whether to escalate emerging problems and whether to intervene with regulatory action. Both regulators have structures for decisions to be made by more senior people, and supervisory oversight functions to assess the quality of supervision. Working-level supervisors we interviewed were concerned that risk appetites had not been explained to them clearly enough, particularly the FCA's approach to smaller firms, affecting how they prioritise work. Some PRA supervisors were concerned that the more judgement-based approach had led to more decisions being taken at senior levels, reducing their own individual decision-making and motivation (paragraphs 2.8 to 2.13).

## Adapting operations to changing approaches

**9 The regulators face challenges in ensuring they have the right staff capacity and capability.** The range and depth of skills required by the regulators has increased as their remits have expanded. In order to implement the changes to regulatory approaches, certain technical competences and behaviours will have to be adopted by the regulators' workforce. The PRA and FCA are currently introducing new frameworks, and feedback on staff training and support has generally been positive. Both regulators are working to develop long-term strategies to attract the best talent. However, current levels of staff turnover result in the consistent departure of skilled and experienced staff, for example 26 per cent of all PRA resignations in 2013 were classified as 'high-performers' and 34 per cent of FCA staff in October 2013 had less than two years' service at the FCA (previously FSA). This could undermine industry confidence in the regulators, poses a risk that knowledge will be lost within the organisations and impacts on the regulators' capacity to carry out their functions (paragraphs 3.2 to 3.9).

**10 The regulators are acting to improve how they collect, use and manage information, but it is too early to conclude on the effectiveness of the new approaches.** The importance of information to the success of the changing regulatory approaches is understood and the regulators recognise the weaknesses associated with the data collection systems inherited from the FSA. The PRA and FCA are working to improve their approach to data collection and are imposing a more disciplined approach to data governance. The regulators do not yet have a complete understanding of their inventories of regulatory data collections and are adopting a more strategic approach to understanding what data are held and what are needed. These approaches are still in their infancy and it is too early to conclude on them. A full evaluation of the changed approaches, and assessments of the proportionality of individual data requests, would require knowledge of the cost to firms of responding to regulatory data requests but the regulators do not currently estimate these. Many of the regulators' data requests are driven by EU requirements. It is important that the regulators understand the cost of compliance to firms even where data requests are driven by EU data requirements as this is necessary information to represent the UK in Europe (paragraphs 3.10 to 3.12).

**11 The regulators have structures for coordinating their work where needed, although achieving this is complex in practice.** A memorandum of understanding and a range of strategic and operational mechanisms have been developed to facilitate coordination at a formal level. In addition to these, good day-to-day interactions between staff at both regulators are important. Working-level communication between the regulators is regular and a good working relationship seems to exist between supervisors, although some staff have raised concerns that this legacy, of when they were working more closely at the FSA, could deteriorate over time. The PRA indicated that there is some uncertainty around what data can be shared and when (paragraphs 1.9 and 3.13).

## Evaluation, performance measurement and reporting

### **12 The way in which regulators use evaluation to measure the costs and benefits of their activities and to direct resources needs further development.**

Each regulator has firm-based risk assessments and the FCA is placing greater emphasis on behavioural economics to understand better how consumers behave and how harm can arise. While the FCA estimates the level of consumer harm in individual reviews, it has not yet established an overall methodology for estimating consumer harm to direct its regulatory activity. Both regulators plan to evaluate different types of regulatory action to help direct resources to where they are most effective, but neither has yet developed an approach to achieving this. Against a rising trend in financial services regulation costs, the regulators have each set out general intentions on future costs: a Bank of England review may provide the PRA opportunities to reduce future costs, while costs could increase as the regulators take on new responsibilities. Because evaluation approaches are not mature, management information does not bring together the benefits and costs of different regulatory activities to allow the regulators to demonstrate that the benefits of their activities always justify the costs, and that the right balance is struck when making staffing and other resourcing decisions (paragraphs 1.19 and 4.2 to 4.6).

### **13 The regulators have established performance measurement systems which could be refined further to improve measurement of the impact they make.**

Each regulator has established a performance measurement framework, set out operational aims and what success looks like, and developed metrics for measuring performance. At present the metrics do not bring together information on whether their intended outcomes are being met and the contribution that each regulator's performance makes in achieving those outcomes. The PRA Board has reviewed and revised its management information in taking an early view on its strategic focus, but the FCA has not yet planned a similar exercise (paragraphs 4.7 to 4.12).

### **14 The regulators have taken steps towards greater transparency but the PRA could develop further.**

The FCA has published a business plan setting out its activities and priorities, while the PRA tells us it intends to publish its business plans when it publishes its Annual Report. In practical terms the PRA's accountability must be taken alongside the accountability of the wider Bank of England, which we found in practice makes or approves resource decisions in relation to the PRA. Over the course of this review the Bank has complied with all NAO information requests. The fact that the NAO does not have statutory access to the financial information held by the wider Bank, however, presents a risk to reporting in future on the economy, efficiency and effectiveness of the PRA (paragraphs 1.13 and 4.14).

## Conclusion

**15** These are still early days for the new regulators. The new regulators come at a higher cost that is borne directly by regulated firms, and ultimately by customers of the financial services industry. There are some encouraging signs that the regulators' changing approaches are bedding down; but for the future, when we return to measure the value for money of the regulators, we will expect them to demonstrate the value that they are achieving for consumers and the taxpayer. Building on their work to date, they will need to link clearly resource allocation to regulatory effectiveness, and demonstrate how they will address the problem of attracting and retaining the right staff to make the more proactive approaches to regulating financial services work.

## Recommendations

- a Over time, the regulators should develop more structured approaches to evaluation of their respective work.** Formal evaluation approaches should be developed forming a cycle of work, building on current cost–benefit analysis and impact assessments, to incorporate planning for evaluation and post-implementation. This should include developing a better understanding of the relationships between regulatory activities, costs and benefits, for both new proposals and existing work, to improve their confidence that resources are directed most effectively. Ultimately the regulators should then make use of this understanding to explain cost changes over longer periods to stakeholders. The FCA should develop and continually update a broader assessment of where harm lies, and use this to direct resources and activity.
- b Over time the regulators should establish a body of evidence from experience of managing potential conflicts between prudential and conduct regulation.** Prudential and conduct objectives can potentially conflict. The regulators should add to their existing mechanisms to deal with these conflicts to help inform and provide greater certainty around future regulatory decision-making.
- c The PRA and FCA should 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 need to develop their expectation as to what an appropriate turnover rate should be and refine tolerance levels accordingly. 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 chosen reflects the target turnover rate.
- d The regulators should evaluate the impact of their new approaches to regulatory data requests.** As part of the new governance arrangements the regulators should estimate the cost to firms of responding to proposed new 'regular' data requests and monitor the impact increased governance and understanding of data inventory are having in practice.



- e The regulators should refine their performance measurement frameworks further and publish their key measures of performance.** There is scope to bring together more clearly the outcomes that they are seeking and measures of performance reflecting the influence they can exert over those outcomes. The PRA should publish operational plans, and both regulators should use their published plans to set out in advance how their performance will be measured over the period covered by the plans.
- f The arrangements for assessing the economy, efficiency and effectiveness of the PRA need to be clarified further.** The legislation provides for examination of the economy, efficiency and effectiveness of the PRA. Since we found in practice that the PRA is administered as a division of the Bank of England, such examinations could require access to financial information held by the Bank. The PRA should work with the wider Bank, and HM Treasury if appropriate, to put in place a formal mechanism to ensure that if financial information is needed from the wider Bank to assess the economy, efficiency and effectiveness of the PRA, it can be accessed.