National Audit Office

Report
by the Comptroller
and Auditor General

The Financial Conduct Authority and the Prudential Regulation Authority

Regulating financial services

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the Prudential Regulation Authority

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This report examines the progress made by the Financial Conduct Authority and the Prudential Regulation Authority in developing and implementing their regulatory approaches to date.

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Contents

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Key facts

£234.2bn	3,815	£664m
estimated value of the UK financial services industry	full-time equivalent employees at the PRA and FCA in December 2013	forecast combined cost of the two regulators in 2013-14

£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.[1] 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.

1 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.

Part One

Background

1.1 The financial services industry plays a key role in the UK economy. It provides a range of services including banking, insurance, pensions and advisory services to businesses and households. It is worth an estimated £234.2 billion (7.7 per cent of UK gross domestic product) and employs 1.13 million people.[2]

1.2 Financial services have characteristics that justify varying degrees of regulatory intervention. 'Conduct regulation' exists to protect consumers where they are disadvantaged in market transactions with financial services providers. Consumers may have limited understanding of financial services products, in part because of the inherent complexity of the products and uncertainty about the benefits they provide. Competition in financial services markets may be ineffective or distorted due to actions by providers or by their employees. There are many rationales for regulation, for example the need to protect financial assets held by providers on behalf of consumers. Because of tax relief provided in relation to some financial services (particularly pensions), the taxpayer may in some circumstances be disadvantaged by misconduct in financial services markets.

1.3 There are also many rationales for 'prudential regulation' and one example is to reduce the risks to consumers and the taxpayer from the failure of providers which could undermine the stability of the overall financial system. In 2008 the government intervened financially in the financial sector, providing support which at its height totalled £1,162 billion.[3] By forcing financial institutions to hold a reasonable quantity and quality of capital reserves, good-quality prudential regulation should reduce the need for future governments to provide so much support.

1.4 Until 31 March 2013 the financial services industry was regulated by a single regulator, the Financial Services Authority (FSA). It was responsible for both conduct and prudential regulation. In 2012, following consultation, the government confirmed its decision to reform financial regulation, in part because in its view the remit of the FSA was so wide before the 2008 crisis that it was not sufficiently focused on financial stability issues.[4]

2 The Office for National Statistics, *The Blue Book 2013*, available at: www.ons.gov.uk/ons/rel/naa1-rd/united-kingdom-national-accounts/the-blue-book--2013-edition/index.html
3 HM Treasury, *HM Treasury Annual Report and Accounts 2011-12*, HC 46, July 2012.
4 HM Treasury, *A new approach to financial regulation: securing stability, protecting consumers*, January 2012.

The new financial regulation framework

1.5 The Financial Services Act 2012 created the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) to replace the FSA. The new regulators formally began operations in April 2013. In practice, the FSA began transition to separation in 2011, and operated conduct and prudential regulation as separate functions internally in the 12 months before it was replaced. The Act also established within the Bank of England the Financial Policy Committee, which can issue recommendations and directions to both regulators relating to financial stability.

1.6 The FCA is responsible for the conduct regulation of around 26,000 firms and the prudential regulation of around 23,000 firms, and in December 2013 had 2,783 full-time equivalent employees. Some firms whose conduct is regulated by the FCA are not required by law to be prudentially regulated. It is responsible for a broader range of regulatory areas, including the prudential regulation of firms that are not covered by the PRA, ensuring good outcomes for consumers and effective competition in financial services markets. It regulates markets, investigates financial crime, and supervises market infrastructures and the functions of the UK Listing Authority. The FCA's statutory strategic objective is "to ensure that the relevant markets function well". It has three statutory operational objectives:

- to secure an appropriate degree of protection for consumers;
- to protect and enhance the integrity of the UK financial system; and
- to promote effective competition in the interests of consumers.

1.7 The PRA is responsible for the prudential regulation of 1,700 of all banks, building societies, insurers, credit unions, and major investment firms with the aim of ensuring that any failure would not undermine the stability of the financial system. These firms are included in the 26,000 firms whose conduct is regulated by the FCA. At the end of December 2013 the PRA had 1,032 full-time equivalent employees.[5] The PRA's statutory objectives are:

- to promote the safety and soundness of firms it regulates; and
- for insurers, to contribute to the securing of an appropriate degree of protection for policyholders.

5 Combined full-time equivalent employees for the regulators in December 2013 was 3,815.

1.8 Both regulators undertake broadly similar regulatory functions, in pursuit of different objectives (**Figure 1**). Some firms are subject to 'dual regulation', with their conduct regulated by the FCA and prudential matters regulated by the PRA. This requires coordination between the two regulators to ensure not only that there is no duplication, but also that there are no gaps in regulatory cover that firms are exploiting.

1.9 A range of formal processes underpin the relationship between the regulators (**Figure 2**). Effective coordination between the two is a requirement of the legislation. A memorandum of understanding sets out their respective responsibilities. Cross-Board representation (where the chief executive of each regulator sits on the Board of the other) allows the senior management of both organisations to work together on key issues. There are also regular formal meetings on different levels from chief executive officer meetings to those at lower levels.

1.10 The regulators acknowledge that their statutory objectives contain elements that may conflict and therefore require careful management. Decisions made by either regulator could affect regulation undertaken by the other. For example, FCA decisions on misconduct that raises firms' profitability could have implications for the PRA if the decision affected the safety and soundness of those firms. Ultimately, the PRA can veto FCA proposals if these would adversely affect its own objectives, although it has not yet exercised this veto. The legislation sets out the circumstances when, and how, the veto can be used. More generally, before any possibility of veto use arises, the regulators have to manage their coordination so that potential (even if remote) conflicts are acknowledged and managed. The regulators currently manage this conflict through their existing coordination processes, although they could build on these by specifically bringing together and sharing their experience of managing such potential conflicts (for example to maximise consistency of regulatory decision-making over time).

1.11 The regulators have already had to manage coordination in cases where both make regulatory decisions on the same matter, and may take different views. In one case example regarding regulators' authorisation for a board appointment at a dual-regulated firm, the PRA was minded to approve appointment, whereas the FCA authorisation team was minded to withhold consent. The FCA Regulatory Transactions Committee, which reviews rejections and finely-balanced decisions, decided there was insufficient evidence to withhold consent and the FCA consented to the appointment. The regulators consider this case unusual but a good example where each is learning from the other's differing approaches and risk appetites, and that these differences were managed professionally in this case while raising some operational challenges, such as managing requests for information from firms where only one regulator requires further evidence. The regulators have reviewed this case as part of their formal processes regarding coordinated working.

Figure 1
Regulators' main functions

Function	Purpose
Authorisation	of firms and individuals to operate in the financial services industry.
Supervision	of firms and individuals to assess risks to consumers and markets.
Policy development	for financial services regulation, including writing rules with which regulated firms and individuals must comply.
Enforcement	of standards through, for example, fines and redress for affected consumers.

Source: National Audit Office analysis

Figure 2
Formal methods of communication between the Financial Conduct Authority and the Prudential Regulation Authority

Strategic

Mechanism	Purpose	Occurrence
Joint Data Management Committee	To provide a strategic view of joint data needs and data-sharing opportunities	Quarterly
Memorandum of understanding meetings	To discuss coordination and performance against the memorandum of understanding	Quarterly
Heads of department meetings	To discuss any outstanding issues	Monthly

Operational

Mechanism	Purpose	Occurrence
Periodic summary meetings	To discuss regulatory actions (FCA and PRA attend each other's meetings)	Annually
Information Governance Board (FCA) and Data Governance Group (PRA)	To facilitate data-sharing between the two regulators and discuss multi-firm new data requests	Bi-weekly
Conflict resolution meetings	To escalate authorisations cases where decisions differ	As required
FCA – PRA colleges	To discuss regulatory actions	As required

Source: National Audit Office analysis

1.12 The legislation makes the FCA and the PRA (separately) accountable to Parliament (**Figure 3**). The FCA is a company limited by guarantee and accountable to HM Treasury which, for example, appoints its Board, although the FCA is operationally independent of government. The PRA is a legal subsidiary company of the Bank of England but is intended to retain operational independence from the wider Bank. The PRA is also accountable to HM Treasury. For example, it requires HM Treasury's approval of its Board members.

1.13 The legislation provides for the PRA to be accountable to Parliament for all of its regulatory functions, and for proposing the budget for the Bank to approve. The wider Bank is accountable to Parliament for a variety of functions relating to the PRA, including approving its budget. In practice we found the PRA is administered as a division of the Bank and is dependent on services provided by the Bank. For example, the PRA does not have its own finance function, but uses the finance function of the wider Bank. An examination of the economy, efficiency and effectiveness of the PRA could require access to financial information held by the wider Bank. Over the course of this review the Bank has complied with all NAO information requests, however as the NAO does not have statutory access to this information, there is a risk that it could be unable to report to Parliament on the value for money of the PRA in the future unless a formal mechanism is in place to access information if it is needed.

1.14 The regulators must coordinate with a range of UK and international organisations. The Office of Fair Trading (which will be replaced by the Competition and Markets Authority from April 2014) has roles in relation to consumer protection and competition in some aspects of financial services. The FCA has oversight of the Money Advice Service's work in improving the ability, and enhancing the understanding, of consumers in financial services. The FCA also has oversight of the system of redress in financial services including both the Financial Ombudsman Service and the Financial Services Compensation Scheme. The FCA shares responsibility for oversight of the Financial Services Compensation Scheme with the PRA. Both regulators also interact with international regulators and other organisations. As the scope of this work is substantial, we have excluded interaction with these other organisations from this initial report and we are likely to return to it in the future.

1.15 Statutory mechanisms exist for independent representation of the financial services industry and consumers. The FCA has a Practitioner Panel (representing the industry as a whole), a Smaller Business Practitioner Panel and a Markets Practitioner Panel (representing financial market participants). Following the 2012 Act a PRA Practitioner Panel, which has just become operational after the process of selecting a chair and members, was established. The Financial Services Consumer Panel is set up to represent the interests of consumers in the development of policy for the regulation of financial services. Following the enactment of the Financial Services (Banking Reform) Act 2013, the Consumer Panel may communicate to the PRA its views on matters it considers relevant.

Figure 3
Accountability in the financial services regulatory framework

Parliament

Sets legislative framework, holds government to account for the regulatory framework. Regulatory bodies are accountable to Parliament for the performance of their functions

Bank of England

Protecting and enhancing the stability of the financial system of the United Kingdom

Appoints members of the PRA Board

Financial Policy Committee

Identifies and monitors systemic risks and taking actions to remove or reduce them (including through directions and recommendations to the PRA and FCA)

HM Treasury

Responsible for the regulatory framework and for all decisions involving public funds

Has the power under the 2012 Act to arrange independent inquiries of both the PRA and the FCA. Reports are to be published

Can appoint an independent person to review the economy, efficiency and effectiveness of the regulators

Can direct the regulators to carry out an investigation into regulatory failure. Reports are to be published

Regulators are required to report annually to HM Treasury and the report is laid before Parliament

Receives the certified accounts of both regulators from the Comptroller and Auditor General and lays the accounts before Parliament

Prudential Regulation Authority

Responsible for the safety and soundness of firms

Subsidiary of the Bank of England

Board appointed by the Bank of England, and approved by HM Treasury

Budget approved by the Bank of England

Operationally independent for the purposes of carrying out its regulatory functions

Has potential to veto decisions of the FCA

Accountable to Parliament

Financial Conduct Authority

Responsible for protecting consumers, promoting competition and enhancing confidence in financial services and markets

Board appointed by HM Treasury

Accountable to Parliament

Source: National Audit Office analysis

Funding and costs

1.16 The regulators are wholly funded through fees levied on regulated firms and collected by the FCA on behalf of both regulators. The regulators' forecast of costs of ongoing regulatory activity (that is the cost of the regulators carrying out their functions as regulators) for 2013-14 is £446 million for the FCA and £218 million for the PRA, a total of £664 million – £127 million more than the equivalent FSA cost in 2012-13. Further transitional costs have been incurred in establishing the two new regulators. In 2011-12 and 2012-13 the FSA spent a total of £43 million on transition, while the Bank of England's own forecast transition costs of £74 million are to be recovered through PRA fees over the five years from 2013-14.

1.17 In April 2013 the FCA and the PRA published reasons for the forecast cost increases in costs of ongoing regulatory activity compared to the FSA in 2012-13.[6] For this report the regulators have further analysed the reasons for the year-on-year increase (**Figure 4**):

- Changing regulatory approaches to supervision, such as higher costs for additional staff on front-line services, amounts to £33.9 million (27 per cent) of the forecast difference.
- The costs of running two regulators instead of one, particularly additional support and premises costs, amount to £37 million (29 per cent).
- Some costs, relating to PRA infrastructure and business transformation (£35 million or 28 per cent) are attributed both to having two regulators and to changing approaches.
- Other factors amount to £21 million (17 per cent). This includes £9 million for the London Interbank Offered Rate (LIBOR) case costs.

1.18 The changes in premises costs in Figure 4 include the costs of the PRA's new premises net of £4 million of forecast savings in 2013-14 for vacating from Canary Wharf, however the Bank of England will continue to pay up to this amount until 2018 under an existing lease. These transitional costs also stem from having two regulators. The Bank will bear these costs from its reserves rather than through fee collection by the PRA.

6 *Regulated fees and levies*: Rates proposal 2013/14, FCA, April 2013, available at: www.fca.org.uk/static/documents/consultation-papers/cp13-01.pdf

Regulated fees and levies: Rates proposal 2013/14, PRA, April 2013, available at: www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/regulatedfeesleviescp3-13.pdf

Regulated fees and levies: rates for 2013/14, PS4/13, PRA, June 2013, available at: www.bankofengland.co.uk/pra/Documents/publications/policy/2013/regfeesleviesps4-13.pdf

Regulated fees and levies: rates for 2013/14, PS4/13, PRA, June 2013, paragraph 26, notes that the Bank and the FSA reviewed the forecast PRA costs based on a counterfactual cost estimate to assess the future cost of prudential regulation on the basis that the FSA had not been disbanded. The budget for the PRA during 2013-14 is below the cost estimate developed during this assessment. We have not evaluated this as it is outside of our scope, as outlined in paragraphs 4, 1.22 and 1.23.

Figure 4

Analysis of ongoing regulatory cost differences between 2012-13 and 2013-14

	Forecast increases due to				
	Changing approaches (£m)	**Additional costs of having two regulators (£m)**	**Both changes in number of regulators and in approaches (£m)**	**Other factors (£m)**	**Total (£m)**
Increases in staff numbers to implement changed regulatory approaches	24.6				**24.6**
Changes in FCA IT infrastructure costs compared to FSA[1]	9.3				**9.3**
Costs of PRA IT infrastructure and projects to complete transition[1]		(0.8)	28.7		**27.9**
Changes in combined depreciation costs[1]			7.0	(0.3)	**6.7**
Additional support costs		27.4			**27.4**
Changes in premises costs		8.6			**8.6**
Additional Value Added Tax costs from FCA recharges to PRA[2]		1.6			**1.6**
Costs of responding to specific events during 2013-14				9.0	**9.0**
Reduction in income to offset costs following Financial Services Authority asset disposal in 2012-13				12.4	**12.4**
Total	**33.9**	**36.8**	**35.7**	**21.1**	**127.5**

Notes

1 The combined FCA and PRA forecast increase in IT and depreciation costs compared to the FSA is £43.9 million. This includes £28.7 million of forecast costs (rather than changes in costs) for the PRA to complete transition to its supervision approach and deliver the associated data strategy and IT changes that support that approach. It is not possible to separately classify this amount, or the £7 million increase in forecast depreciation costs, between changing approaches and the costs of having two regulators.

2 The regulators have since learned that VAT is not applicable to FCA recharges, which would reduce the forecast by £1.6 million.

Source: Financial Conduct Authority and Prudential Regulation Authority

1.19 After 2013-14 the costs of ongoing regulatory activity could fall or rise. The trend in costs of financial services regulation is upwards, as the FSA's costs increased by 9 per cent in 2011-12 and in 2012-13. The Bank of England's intention is that the PRA will operate, in the medium term, at lower cost on a like-for-like basis than its equivalent part of the FSA, and a Bank of England review could have an impact on the PRA's future costs.[7] The FCA has said it is forecasting no increase in 2014-15 regarding its inherited responsibilities, although its costs would rise to reflect new responsibilities such as taking over consumer credit from the Office of Fair Trading in April 2014.[8]

1.20 In addition to the regulators' forecast costs, section 166 of Financial Services and Markets Act 2000 (FSMA) gives the regulators the power to obtain an independent view of aspects of a regulated firm's activities which cause the regulators concern or where they require further analysis. Appointment of the skilled person can either be by the regulated firm, or (following the Financial Services Act 2012), directly by the regulators. In each case scope is set by the regulator and review costs are payable by the regulated firm. In 2012-13, the FSA total costs in relation to skilled person reviews were £176.4 million, of which £141.5 million of these costs related specifically to the interest rate hedging products reviews. Between April and December 2013, the FCA commissioned 40 skilled person reviews (in-progress and completed), with an estimated total cost to the regulated firms of £140 million, of which a significant proportion related to a review cited in the FSA's 2012-13 Annual Report, which was commissioned just prior to the year-end date and therefore a reliable cost estimate was unavailable at that time. The PRA commissioned 22 skilled person reviews at an estimated total cost to the regulated firms of £9 million. The regulators' cost estimates include actual costs, for those reviews which have completed, and estimated costs where actual costs are not yet available. Each regulator publishes quarterly updates on the number of reviews commissioned, and each regulator will publish totals for its financial year or period in its respective annual report. For the FCA this will include review figures for January to March 2014 and for the PRA January to February 2014, which are currently outside the figures quoted in this report.

7 Bank of England, *Annual Report 2012*, p. 36, available at: www.bankofengland.co.uk/publications/Documents/annualreport/2012/ar2012.pdf

8 Financial Conduct Authority, evidence to the Treasury Select Committee, 10 September 2013.

1.21 The fees recovered from firms by the FCA also include amounts, collected as separately structured levies, attributable to the funding activities of the Money Advice Service, the Financial Ombudsman Service and the Financial Services Compensation Scheme. In 2013-14 these combined costs are forecast to be considerably higher than the costs of the two regulators, at £1.18 billion. The FCA forecasts that in 2013-14 it will recover combined costs of ongoing activity of the three organisations amounting to £388 million,[9] and £791 million collected by the Financial Services Compensation Scheme relating to capital and interest repayments on the major banking default loan from HM Treasury. In addition the Financial Ombudsman Service collects their own case fees and group fees (not collected by the FCA), forecast at £261 million for 2013-14. These activities fall outside the scope of this report.

Scope of audit

1.22 The National Audit Office (NAO) was not the statutory auditor of the FSA. The Financial Services Act 2012 made the NAO the statutory auditor of the FCA and the PRA from April 2013. The NAO does not have statutory audit rights over the wider Bank of England or the Financial Policy Committee.

1.23 This report examines the progress made by the FCA and the PRA in developing and implementing their changing approaches to date. It is too early for us to form an opinion on the value for money achieved by each regulator so far; we intend to report on this in future reports. The report makes no evaluative assessments of organisations over which we have no statutory audit rights.

9 This total comprises Money Advice Service £78 million, Financial Services Compensation Scheme £285 million and Financial Ombudsman Service £25 million.

Part Two

Approaches to regulatory decision-making

2.1 This part examines how the regulators have changed the way they interact with the financial services firms to achieve their regulatory objectives and the decisions they have to make in authorising, supervising and taking enforcement action against firms.

Changing approach for interaction with firms

2.2 As independent regulators, both set rules in line with UK and EU legislation and international agreements; rules are published in a handbook. The regulators seek to use rules and their application through supervision to incentivise firms to adopt the kinds of behaviour that the regulators expect, alongside published guidance, speeches and ‘roadshows’. The regulators authorise firms, supervise them to ensure they are following the rules, and take enforcement action where necessary to deal with non-compliance.

2.3 In developing their approaches to carrying out these functions, the regulators have sought to learn lessons from the FSA’s experience of regulation. The Parliamentary Commission for Banking Standards and the Treasury Select Committee identified and reported weaknesses in the FSA’s regulatory approaches through various reports on banking and regulation.[10] Both regulators plan a more judgement-based, forward-looking and proactive approach to regulatory decision-making. To some extent the FSA began shifting towards these approaches prior to separation into two regulators.

Authorisations

2.4 Firms and individuals must be authorised to carry out regulated activities. Applicants are assessed against a set of statutory threshold conditions, which are the minimum requirements to be met for authorisation. Where firms and individuals are ‘solo regulated’ the FCA makes an assessment on conduct and prudential issues. In ‘dual-regulated’ cases, the conduct and prudential assessments are split between the FCA and PRA, with the PRA taking the single administrative lead. The regulators must make decisions within the timeframes established by statutory service standards, against which performance is measured. Performance is also measurable through the regulators’ own (internal) voluntary services standards and, for example, using average case length.

10 For example, *Changing Banking For Good*, Parliamentary Commission for Banking Standards, July 2013.

2.5 Statutory service standards are breached when a single case falls outside the timeframes. Data on the regulators' performance against statutory standards between April and December 2013 (**Figure 5**) indicates no significant improvement nor deterioration in the number of standards breached, compared to the FSA's comparative performance for those months in 2012-13, although the number of cases leading to a breach since April 2013 was lower over the period. The regulators have one common voluntary service standard for authorisations, where a breach occurs if compliance falls below 90 per cent. There have been more breaches of this voluntary standard since April 2013 than by the FSA in the comparative period.

Figure 5

Authorisation performance to service standards: analysis of the number of cases falling outside comparable standards between the Financial Services Authority, Financial Conduct Authority and Prudential Regulation Authority

	Type of service standards	Number of service standards	Number of breached service standards (FSA: April–December 2012) (FCA and PRA: April–December 2013)										Number of cases falling outside standards
			Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	
FSA – 2012	Statutory	11	5	6	0	3	2	3	3	5	2	**29**	48
FCA – 2013 (solo cases)	Statutory	11	0	2	0	1	1	3	2	1	1	**11**	16
PRA – 2013 (dual cases)	Statutory	11	2	0	1	1	3	2	1	2	1	**13**	18
FSA – 2012	Voluntary	1	0	0	0	0	0	0	0	0	0	**0**	41
FCA – 2013 (solo cases)	Voluntary	1	0	1	1	0	0	0	1	0	0	**3**	15
PRA – 2013 (dual cases)	Voluntary	1	1	1	1	1	0	1	1	1	1	**8**	66

Note

1 The Financial Conduct Authority reports on solo regulated cases, and the Prudential Regulation Authority reports on dual-regulated cases.

Source: National Audit Office analysis of Financial Services Authority, Financial Conduct Authority and Prudential Regulation Authority data

2.6 Industry views were generally positive that the regulators make clear expectations on times to complete cases, but that case length can be longer than expected.[11] The regulators have identified speed of case processing as an area for improvement, particularly in dual-regulated cases where time spent on new firm authorisations increased from an average of 38 weeks to 41 weeks between April and December in 2012 and 2013 respectively. Both regulators attribute slower case times here to a combination of how the regulators coordinate, complexity of dual-regulated cases, regulators' resource constraints, and increasing caseloads. There is no formal plan to address the issue of speed, but the regulators say that experience in coordination and the forward plans for improved resource allocation may improve performance. The regulators have launched a new process of banking applications, one of the outcomes of which was to streamline the process which they hope will speed up the process. The regulators are also aiming to use earlier engagement with firms to speed up authorisation applications (**Figure 6**).

Figure 6

Earlier engagement with firms for authorisations

The regulators aim to engage more with firms through greater use of pre-application meetings for more complex applications, typically from dual-regulated firms. The purpose of these meetings is to ensure that submitted applications are complete by informing firms of the requirements, setting expectations and enabling staff to handle more complex cases. Over time, the regulators should be able to measure the impact of this work on both application times and, potentially, on the quality of their authorisation decisions.

Source: National Audit Office analysis

Supervision

2.7 Supervision activity assesses the risks that firms pose to the regulators' objectives. The regulators provide more intense and frequent supervision to firms with the greatest potential to adversely affect financial services markets and cause consumer harm (in the case of the FCA) and the stability of the UK financial system (in the case of the PRA). The relationship between supervisors (individuals and teams) and regulated firms is a key element of both regulators' ability to achieve their objectives. Supervisors are responsible for reviewing the risks that a firm poses to the respective regulator's objectives, with potential problems escalated to more senior regulatory staff. We obtained industry feedback through semi-structured interviews and a small survey of financial services firms and industry bodies. **Figure 7** summarises some of the views of our interviewees and survey respondents to changing approaches to supervision.

11 Based on our fieldwork and survey evidence gathered by the Financial Conduct Authority.

Figure 7

Mixed views on changed approaches to supervision at the Financial Conduct Authority

The FCA has separated 'events'-based supervision and thematic reviews from firm-based supervision, for example a thematic review of annuities and their impact on retirement income. Industry respondents generally welcomed thematic reviews. However, they noted examples where the work of day-to-day supervisors and the thematic review teams was not sufficiently well coordinated. They raised concerns that the thematic review teams may not use supervisors' firm-specific knowledge enough to improve their own understanding of the firm, and creating the possibility of duplicated information requests. Some industry respondents also thought that the FCA had started thematic reviews without appearing to prioritise which were most important, and had not always demonstrated evidence of consumer harm in advance as a clear rationale for beginning individual reviews. Some resources have been transferred from firm-based supervision to thematic reviews; consequently there are more firms in the 'lower potential impact' categories who deal with the regulator through its contact centre rather than through named supervisors. Smaller firms and their representatives are concerned that they receive advice from fewer named supervisors and therefore turn to the contact centres which they find could be more helpful on how to meet conduct expectations and comply with the rules.

Source: National Audit Office analysis

2.8 We obtained feedback from working-level staff at the regulators through focus groups with supervisors at the FCA and reviewing the PRA's own staff feedback reports. Working-level supervisors at both regulators said the changing approaches have had practical benefits in providing clearer separate focus and greater depth to prudential and conduct work, and encouraging earlier and more decisive regulatory intervention. Some PRA supervisors considered that, under the current decision-making structure and more judgement-based approach, too many decisions are being taken by committees rather than individual supervisors. Consequently, supervisors now spend considerable time writing papers for senior staff exercising judgements and some have become demotivated because they do not have individual decision-making responsibility. Supervisors at both regulators raised concern about how well the regulators have set out their risk appetite. Supervisors at the FCA raised particular concerns about their understanding of risk appetite among firms perceived as being less risky and remarked that they lacked guidance on when to intervene in issues arising with these firms. As a consequence supervisors felt it was difficult to prioritise work and allocate resources in order to address risks, which has created challenges to the risk-based approach of the FCA.

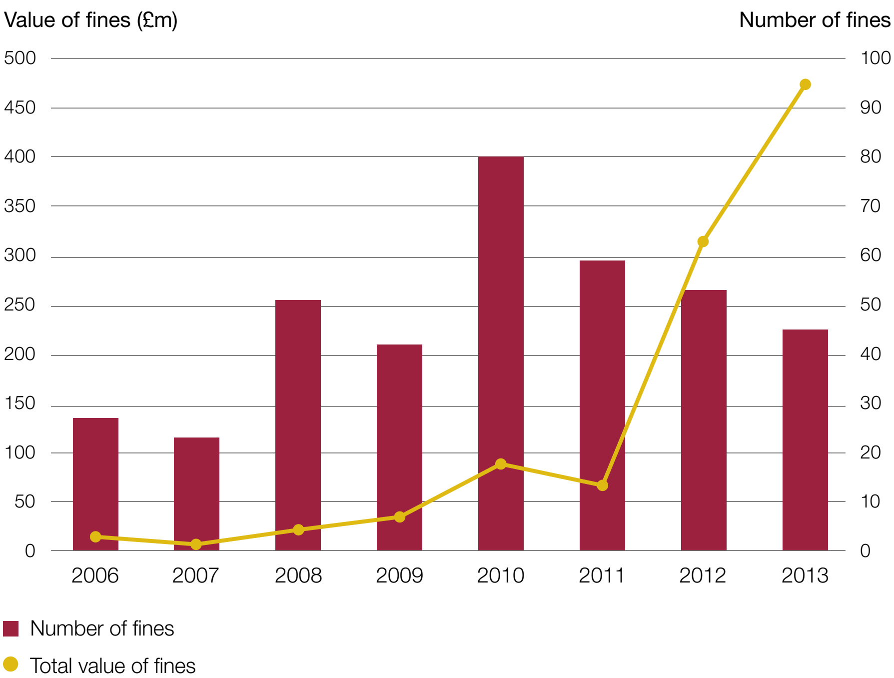
Enforcement

2.9 Enforcement involves using regulatory powers to deter firms from breaking rules, and to act against firms when they do. The regulators have a variety of formal powers available under statute, which they can use in the course of supervision if deemed necessary to reduce risks. For example, regulators can require information from firms; commission reports by third parties into specific areas of interest; issue prohibitions and customer warnings; initiate prosecutions and, in some instances, impose fines on firms that break regulatory requirements. Both regulators state their commitment to taking action at the earliest possible stage in order to provide better outcomes for consumers and the UK economy.

2.10 It is too early to tell whether the FCA is making greater use of enforcement than the FSA. Activity measured by the total number of fines imposed increased from 2006 to a peak of 80 fines in 2010, since then it has decreased (**Figure 8**). The total value of FSA fines imposed increased sharply in 2012 to £312 million, and to £472 million in 2013 (FCA from April 2013). The FSA was required by legislation 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 which had not been fined the following year. Fines levied by the FCA are now paid (net of FCA enforcement case costs) to HM Treasury. Consequently, firms not fined no longer receive a discount to their fees from fine revenue except so far as enforcement case costs are covered.

Figure 8

Total number and value of fines imposed from 2006 to 2013



Note

1 Fines imposed by Financial Services Authority to 31 March 2013, and by Financial Conduct Authority thereafter.

Source: National Audit Office analysis of Financial Services Authority and Financial Conduct Authority data

Understanding of risk

2.11 This changing approach requires the regulators to develop a better understanding of the risks to their respective objectives, continually updated in light of market developments. The FCA has segmented firms into four categories for conduct regulation, based on the number of retail customers and on measures of the potential impact on its objectives; and four categories for prudential regulation, reflecting the nature and the impact that their failure would have on the market. The PRA segments firms into five categories based on the potential impact of the firm on the stability of the UK financial system, which depends on its size, complexity, business type and interconnectedness with the rest of the system.

2.12 Based on the risk appetite set out by both regulators, each has developed criteria to help inform decisions on whether to intervene formally, when, and by how much. The PRA, for example, has developed a proactive intervention framework, which it uses to assess a firm's risk of financial failure and guide its own responses based on that assessment. In authorisation and supervision, both regulators use the hierarchy of decision-making to allocate more complex decisions to more senior committees and staff and, for the PRA, ultimately to Board level.

The importance of oversight functions

2.13 Both regulators review the quality of decisions made by authorisation staff. The complexity of judgement-led decisions in specialist cases can be more difficult to review without the necessary skills and expertise. The regulators focused initially on familiarising staff with the process, and they are in the early stages of implementing authorisation quality assurance models. In supervision, both regulators also operate supervisory oversight functions to review the quality of decision-making. Both regulators learn lessons from regulatory experience through these oversight functions and their respective internal audit functions. The Financial Services Act 2012 provided for reviews in the event of regulatory failure; the regulators are still developing their approaches to undertaking these reviews.

Part Three

Adapting operations to changing approaches

3.1 This part examines the two regulators' skills and capacity, information and coordination with each other in achieving the changed regulatory approaches.

Skills and capacity

Developing and adopting new regulatory skills

3.2 The range and depth of skills required by the regulators have increased as their remits have expanded, for example the FCA's new competition objective. To implement the changes in regulatory approaches, certain technical competences and behaviours will have to be learned and adopted by the regulators' workforce. Both regulators have developed frameworks that identify a new set of skills and behaviours to adopt in their respective organisations (**Figure 9**). The PRA has developed a competency framework which identifies eight technical competency areas to inform staff of their required role-specific skills. The FCA has introduced a capability framework in order to create a common set of conduct skills and behaviours throughout the organisation and to redevelop specific technical competencies for each business area; the first of these (supervision) is to be completed in April 2014.

3.3 The regulators are in the process of introducing the new skills frameworks to staff. It is too early to draw conclusions on whether these skills have been adopted by staff yet and supervisors at the FCA acknowledge that they are still inexperienced in implementing in practice the changes in the way the FCA supervises firms. Feedback from our survey of financial services firms and industry bodies was generally positive on the levels of skills displayed by supervisors. In particular, PRA supervisors were commended for their specialist knowledge, though firms acknowledged that this may be partly as a result of the broader scope of the FCA's remit. A minority of firms felt that both PRA and FCA supervisors lack practical experience of working in the markets at operational or business management level.

Figure 9
The regulators' competency and capability frameworks

PRA competency framework	
Supervision	PRA regulatory organisation and structure
	Supervisory approach
	Financial analysis
	Business strategies and models in their market and economic context
	Governance, oversight and controls
Prudential policy	Developing and implementing policy
Risk specialists	Specialist risk
Supervisory oversight	Quality assurance
FCA capability framework	
Five cultural characteristics	Backbone
	Professional excellence
	Curiosity
	Already on the case
	Strength as a team
Three personal strengths	Judgement
	Drive
	Influence
Technical competencies	Divisional/role-specific (inherited from FSA, currently being redeveloped)

Source: Prudential Regulation Authority and Financial Conduct Authority

3.4 To help implement the changes to regulatory approaches, the regulators have provided staff training and supporting tools. Feedback from working-level staff at both regulators indicates that these have been positively received, with some exceptions. Supervisors in both regulators were generally positive about the training provided in preparation for working in the PRA and FCA. Since then the regulators have been developing their understanding of their current capability and potential skills gaps. PRA training is delivered by the wider Bank, which undertook an analysis of training needs for the PRA. Future training provided will need to address some of the early concerns some supervisors had with the provision of technical training. Supervisors at the FCA remarked on the variable quality of core module training provided which was subsequently paused, before resuming in early 2014 after improvements had been made. Staff in both regulators commented positively on the support tools and guides offered to help with implementing the changing regulatory approaches. The FCA's 'how to' staff guides and the PRA's supervisory framework tool, which sets out the key policies and processes that supervisors should follow when supervising firms, were noted for being particularly useful. However, an analysis of feedback from PRA working-level staff identified that the PRA's decision-making framework tool, which sets out who should take decisions and how judgements should be reached, was considered ineffective by some staff in the early stages of operations.

Recruiting and retaining staff

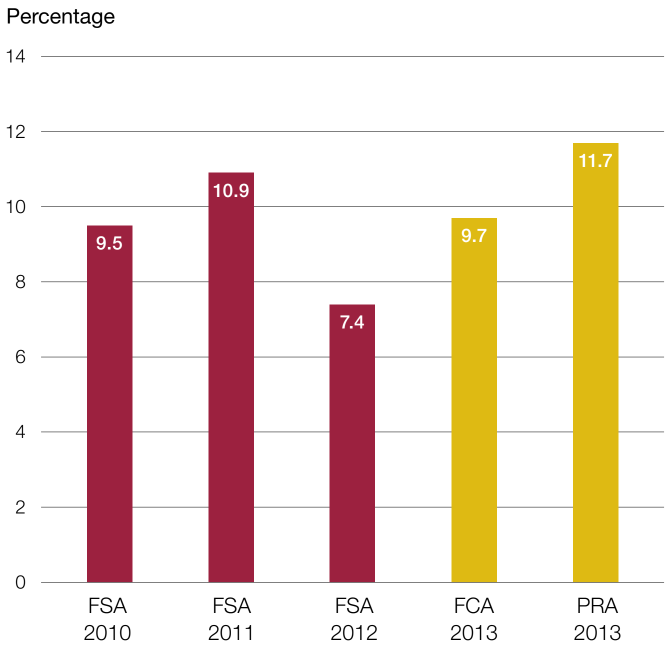
3.5 Attracting skilled staff is a key challenge for the regulators. They are both developing long-term strategies to attract and recruit talented staff by improving their overall staff offer. The FCA recently agreed a new people strategy, which signals a long-term approach to staff recruitment based on becoming the leading organisation for training in conduct regulation. The FCA's future recruitment strategy aims to attract talented staff through the prospect of improved future career progression within industry through developing key regulatory skills. Early in 2014-15 it hopes to launch a new, more competitive, employee value proposition and a 'supervisor diploma'. Integrating the PRA and the wider Bank has been a challenging human resource exercise and the Bank is currently operating three different remuneration models with approximately one-third of staff in each scheme. The PRA remuneration and employment proposition is being reviewed as part of a Bank-wide review of terms and conditions that is expected to be completed in March 2015.

3.6 Separation did not lead to a significant short-term increase in annualised staff turnover (**Figure 10**). Between April and December 2013, 247 staff resigned from the FCA and 91 staff resigned from the PRA resulting in annualised staff turnover rates based on monthly resignations of 9.7 per cent and 11.7 per cent respectively. The majority of leavers from the PRA took up positions within the banking, insurance and professional services industries. In December 2013 the PRA found that 35 per cent of staff (32 staff) left the organisation for better prospects. PRA exit surveys in November 2013 identified transition to the Bank, limited or unclear advancement opportunities in the Bank, hierarchical culture and pay as reasons for leaving. Of those who completed an exit survey, 81 per cent had secured an increase in their basic pay in their new role.

3.7 Each regulator has its own staff turnover tolerance range. In December 2013 the FCA was within its 7 to 11 per cent band. At the time of our fieldwork the PRA established its tolerance range of 7 to 10 per cent, which is higher than the wider Bank. In December 2013, PRA staff turnover was outside this accepted level (Figure 10). According to benchmarks used by the PRA, both regulators' turnover rates are lower than the average resignation rates for private sector services firms (12.2 per cent) and financial services firms (13.4 per cent), but higher than the average resignation rate for public sector organisations (8.1 per cent). Current levels of staff turnover result in the consistent departure of skilled and experienced staff. Between April and December 2013, 31 per cent of all staff who resigned from the FCA were identified as 'high-performers', while 26 per cent of all PRA resignations over the same time period were classified in this category. This is above the Bank-wide target of less than 20 per cent, indicating it is losing too many highly rated staff. The regulators also monitor staff experience levels, and in October 2013 34 per cent of FCA staff had less than two years' service at the FCA (previously FSA). In September 2013, 21 per cent of associates and managers within the PRA had less than two years' service. The proportion of inexperienced staff is expected to increase as an influx of new recruits is planned.

Figure 10

Staff turnover year on year (percentage): comparison between the Financial Services Authority, Financial Conduct Authority and Prudential Regulation Authority



Note

1 Financial Conduct Authority and Prudential Regulation Authority data as at December 2013.

Source: National Audit Office analysis of Financial Services Authority, Financial Conduct Authority and Prudential Regulation Authority data

3.8 Our survey of financial services firms and industry bodies indicated that the departure of skilled and experienced staff could undermine industry confidence in the regulators and poses a risk that knowledge will be lost within the organisations. Although generally positive on the levels of skills displayed by supervisors, survey respondents warned that high levels of staff turnover in the regulators, and in particular at the PRA, is limiting the ability of supervisors to understand the firms that they are supervising. Staff turnover is one factor that affects the length of supervisor tenure on individual firms. In September 2013, 76 per cent of PRA supervisors had less than two years' tenure with the firms they supervise and this number is expected to increase as the regulators recruit new staff. To retain some regulatory experience held by leavers the PRA has hosted a number of staff seminars giving leavers an opportunity to share their knowledge before moving on. At the time of our fieldwork, the PRA expected to provide a new 'Risk Manager System' in 2014 that enables supervisors to monitor and record firm risks. Among the expected benefits of this programme will be greater continuity of case management where staff change between cases.

3.9 Challenges in resourcing represent one of the most significant operational risks to both regulators. The FCA and PRA risk registers identify that current staffing levels may be unsuitable and could potentially affect the regulators' ability to achieve their objectives. For example, they identified risks to PRA firm supervision and to specific projects at the FCA, such as the information systems investment programme. Working-level staff at both regulators noted that resources are stretched which could affect their ability to implement the changed regulatory approaches. Both regulators are currently recruiting.

Information

A new approach to regulatory data requests

3.10 Both regulators recognise the weaknesses associated with the data collection systems inherited from the FSA. These included: too much data collected without clear purpose, within unrealistic timescales; limited suitability of IT and governance over data; and not showing clearly how data were used. The changes to regulatory approaches require regulators to collect good-quality information in order to make sound judgements. One of the most important information sources is regulatory data requests which require regulated firms to report a wide range of data.

3.11 Following EU requirements on data collection, the regulators are working to improve their approaches and have prioritised imposing more disciplined data governance. Since separation, the regulators have established new formal structures to improve data collection, including a Joint Data Management Committee to provide a strategic view of joint data needs and data-sharing opportunities. The FCA established an Information Governance Board to oversee the implementation of its data strategy. The PRA created a Data Board to discuss data issues at a strategic level. All proposed new requests for 'regular' data from firms must be approved by the Data Governance Group at the PRA, and the Information and Governance Board at the FCA. Supervisors at the FCA noted the increased role of the Information Governance Board and remarked how challenging it had been on new requests. They agreed with the rationale for this level of challenge and acknowledged that while it can sometimes hold up their work, it does not critically impede their ability to carry out their role.

3.12 The regulators do not yet have a complete understanding of their inventories of regulatory data collections, in particular adhoc requests, which account for about 50 per cent of PRA collections. However, the FCA is developing a data collection toolkit to catalogue the data it has in stock, and map it against its data requirements. The project is expected to be complete in 2015. The PRA has begun a project to systematically review its complete data inventory against identified data requirements, with the aim of reducing the number of adhoc data collections and streamlining requests into a more effective handbook return. This is a long-term objective; the project began in 2013 and the data stocktake stage is expected to be completed in 2015, followed by public consultation and implementation to 2018. For example, 'balance sheet' collections are among the most advanced of the PRA's stocktake and proposals for this envisage a reduction in the number of data returns from seven to two. The case example in **Figure 11** (overleaf) provides feedback from firms and staff at the regulator on the current approaches to regulatory data requests.

Joint working

Working between FCA and PRA on a day-to-day basis

3.13 In addition to the formal structures in place to facilitate coordination between the FCA and PRA (paragraphs 1.9 to 1.11), good day-to-day working relationships and interactions between staff at both regulators are important, in particular to ensure that the burden placed on firms when interacting with the regulators is minimised. Working-level communication between the regulators is regular and a good working relationship seems to exist between supervisors, although there are concerns that this legacy of when they were working more closely at the FSA could deteriorate over time. Industry views tend to highlight that coordination between the regulators can be poor where the firm is too small to warrant a named supervisor at the FCA. The case example in **Figure 12** (overleaf) shows views on how the regulators interact on a working level with respect to regulatory data requests.

Figure 11
Case example: regulatory data requests in practice

Industry views on responding to regulatory data requests

Firms felt that that the regulators clearly communicate requests but were less clear on why the data are being collected, leading to particular difficulty in understanding the scale and depth of the data required. Firms also felt that the timescales given to provide the information do not always reflect the level, complexity and scope of the data requested. Respondents suggested that the time lag between submitting the requested data and getting insight from the exercise can be long.

The regulators have not appraised the effect that the new approaches to data requests will have on firms. Neither regulator estimates the cost to firms of complying with regulatory data requests. Many of the regulators' data requests are driven by EU requirements and it is important that the regulators understand the cost to firms of compliance as this is necessary information to represent the UK in Europe.

Regulatory data requests and information technology

The regulators acknowledge that they do not have the technology needed to fully exploit the data and information provided. Staff at the PRA described shared information systems, such as the reference data management system ('TARDIS') and the business intelligence system for regulatory returns ('COGNOS'), as being difficult to use and raised concerns about the analytical capability that they provide. The memorandum of understanding states that the FCA and PRA will consult one another on shared data definitions to allow for the efficient sharing of data, however they do not currently share a common 'data dictionary' (a common understanding of different pieces of information). Industry noted that some requests still need to be submitted manually rather than on the regulator's online reporting system (e.g. professional standards data), and that it would be helpful to firms if all data was submitted in the same way.

Source: National Audit Office analysis

Figure 12
Case example: day-to-day coordination between the Prudential Regulation Authority and Financial Conduct Authority on regulatory data requests

Early feedback from supervisors at the FCA suggests that there has been lots of informal engagement between the regulators with respect to data-sharing and the principles set out in the memorandum are working well in practice. In particular, there have been bilateral conversations between the FCA and PRA with respect to data inventory work and regular supervisor-to-supervisor discussions occur, particularly with respect to new data request proposals.

The PRA indicated that they have some uncertainty around what data can be shared and when. There are limitations to data-sharing and neither regulator has absolute freedom to provide the other with the data it requests. Complexities around the legislative framework and market sensitivities sometimes make it unclear when data can and cannot be shared. In response to this challenge the PRA has created confidentiality and disclosure guidance for staff which consists of case study examples and tips for sharing data with other parties. The PRA acknowledges that it will take time before this understanding is fully embedded among staff.

Firms we surveyed consider that since April 2013 dual regulation has increased the number of data requests they receive, but acknowledge that it is too early to conclude on this as the regulators' approaches are only beginning to be adopted. Firms identified a number of positive examples of the two regulators working together on data requests, in particular the regulators' business model analysis for which one combined information request was submitted.

Source: National Audit Office analysis

Part Four

Evaluation, performance measurement and transparency

4.1 This part examines how the regulators use evaluation to direct the use of different regulatory tools and operational resources, to measure performance against their respective objectives and to demonstrate transparency.

Evaluation

Evaluating risk and consumer harm

4.2 Both regulators have developed understandings of risks that firms pose to regulatory objectives, to direct allocation of supervision resources and activity. The FCA has estimated consumer harm in specific areas during thematic reviews, to help identify the appropriate conduct regulation response. Measuring harm to consumers is a complex assessment requiring knowledge or estimates of the harm to an individual consumer and of the number of consumers affected, across a range of different products. The FCA is placing greater emphasis on using behavioural economics to understand better how consumers behave and how harm can arise.

4.3 The FCA has not yet developed an overall methodology for estimating consumer harm to direct regulatory activity more broadly. An integrated understanding of where harm can arise across all areas of responsibility is important in informing regulatory decisions about how and when to act. This is particularly the case where new responsibilities are assumed, for example FCA's new competition role requires understanding of potential harm to consumers from anti-competitive behaviour, and responsibility for consumer credit from April 2014 requires understanding of how particular groups of consumers are affected by misconduct. Drawing together more formally its evolving understanding of harm in all these areas would give the FCA greater confidence that it is allocating resources to areas of greatest harm to consumers. The FCA can learn from work undertaken by others, particularly the Office of Fair Trading, in developing its approach to a wider assessment of consumer harm.

Evaluating costs and benefits of regulatory action

4.4 It was likely that the costs of regulation would rise (compared to the FSA's costs), at least in the short term, because of the costs of establishing two separate regulators, decisions to increase IT investment, changing regulatory approaches, and ongoing expansion in regulatory responsibilities. It is important that the costs of regulating financial services are set in the context of the benefits that accrue to consumers and potentially taxpayers if the objectives of regulation are met more effectively. Currently there is limited information on the benefits that accrue from regulation at the level of individual regulatory interventions (for example, deterrent effects attached to enforcement action) or broader areas of regulatory work. Future assessments of the value for money provided by each regulator will reflect the evidence on whether their objectives are being achieved at an efficient cost. Over time each regulator will need to develop approaches to evaluation and performance measurement so that it can draw together information on achievement of objectives with the costs and benefits of different regulatory activities, ranging from individual initiatives to programmes and strategic objectives.

4.5 Both regulators have stated that they will evaluate use of regulatory tools to inform future regulatory decisions, but the regulators have not yet developed formal approaches to evaluation to help them achieve this. To date the regulators have made use of impact assessments covering regulatory proposals before they are introduced. Both regulators plan to make use of post-implementation reviews of initiatives to help direct their resource use. Neither regulator has established a strategy which provides for a cycle of evaluation from impact assessment and planning for evaluation through implementation to post-implementation reviews; and which would help them prioritise between evaluation of different types of regulatory activities.

4.6 In addition to the costs of funding regulators, firms incur the costs of responding to and complying with regulatory requirements and activities. The regulators do not routinely collect or hold information on the cost of compliance, nor have mechanisms to estimate these costs. Without information on or estimates of compliance costs, regulators may underestimate the costs of regulatory proposals (including regulatory data requests) or existing activities, which hampers their ability to assess whether the benefits justify the costs. In undertaking cost–benefit analysis regulators need to assess whether the appraisal or evaluation itself is proportionate, and knowledge or estimates of compliance costs may in some situations be central to an informed decision.

Performance measurement

Measuring performance against objectives

4.7 Both regulators have translated their statutory objectives into more specific objectives, and have frameworks for measuring performance against their objectives and are continuing to develop these further. The FCA has identified four desired outcomes for each of its three operational objectives (for example, under the consumer protection objective: fair products and services; improved consumer experience; building trust and engagement; effective remedies). Each desired outcome has one or two indicators. To measure its own performance, the FCA also currently reports divisional activities under seven interim success measures, and has published eight success measures which it is considering using to measure its own performance for the longer term.

4.8 For each of its business aims, the PRA has identified summary objectives, initiatives and projects, deliverables with milestones, performance indicators and targets where applicable, and risks to achieving objectives. The PRA is also developing success criteria against which it plans to measure its performance, together with indicators it would use to measure whether it is achieving success. The PRA is planning a feedback process whereby a metric will measure management response to performance.

4.9 There is scope for the performance metrics of each regulator to bring together more clearly whether their desired outcomes are met, how much influence they have over those outcomes, and how they are performing where they can exert influence. The FCA has indicators of desired outcomes but (because these do not yet link strongly to its proposed success criteria) a less clear picture of how the FCA's actions have affected these. The PRA's performance indicators are linked more closely to what they can influence, but they could link more clearly to the (more outcome-based) success criteria that they are still developing.

4.10 The FCA's performance indicators draw on a range of sources, including the Financial Ombudsman Service, the European Commission and private sector data, as well as its own. The PRA's performance indicators mostly draw on its own data.

Management information and its use

4.11 The PRA Board uses management information prepared for it, and has changed the format and content to make the information more useful to it in reviewing strategic focus. For example, the PRA produces performance and risk information for management on a quarterly basis reporting on operational, strategic, supervisory and policy performance, sector risk and supervisory assurance.

4.12 The FCA produces a performance report for the Board covering the FCA's performance against its statutory objectives on a sector basis, with a different sector reported at each quarter so that each sector is covered at least once annually. The management information also covers operational performance at the divisional level. The FCA has not yet planned a review at the Board level of its management information.

Transparency

4.13 Under the legislation both regulators must exercise their functions transparently; the legislation also restricts the information that each regulator can publish to explain their decisions. The FCA has consulted on a proposed approach to demonstrating transparency in decision-making.

4.14 Both regulators have produced business plans setting out their planned activities and priorities. In March 2013 the FCA published its Plan for 2013-14, and plans to publish its Plan for 2014-15 in March 2014. Its 2013-14 Plan did not set out how its performance for the year would be measured, although its performance measurement framework was still being developed at that stage. The PRA did not publish its Business Plan for 2013-14, however it has informed us that it plans to publish the 2014-15 Plan with its Annual Report. Both regulators have set out examples of how they will measure performance in other published documents, although they have not to date brought these measures together and published them in one place.

Appendix One

Our audit approach

1 This study examines the progress made by the FCA and the PRA in developing and implementing their regulatory approaches to date. To do this:

- we identified the responsibilities and objectives of the new regulators, together with formal mechanisms for coordinating their work where it is needed, and the accountability arrangements. We reviewed the regulators' forecast costs for 2013-14 together with reasons for changes in costs compared to the FSA in 2012-13;
- we identified the regulators' changing strategic approaches to interacting with firms and decision-making, and examined how these are being implemented in their authorisation, supervision and enforcement work;
- we examined how the regulators are in practice adapting their approaches to skills, information collection and use, and coordination with each other, in light of their changing approaches to regulatory decision-making; and
- we reviewed how the regulators use evaluation to direct their resources, and how they each measure and publish information on their performance.

2 Our audit approach is summarised in **Figure 13** overleaf. Our evidence base is described in Appendix Two.

Figure 13
Our audit approach

The objective of government

To effectively regulate the financial services sector (where markets are not themselves delivering optimal outcomes).

How this will be achieved

The PRA focuses on the prudential stability risks to financial institutions and of the system while the FCA focuses on the risk of poor conduct.

Our study

The study examines the progress made by the FCA and the PRA in developing and implementing their regulatory approaches.

Our area of focus

- The regulators' objectives, accountability arrangements and forecast costs for 2013-14.
- Changes in how the FCA and PRA regulate, including how they are implementing their approaches in practice.
- Changing approaches to skills and to information collection and use; and coordination between the regulators in practice.
- How the regulators are measuring their performance and evaluating the benefits of regulation.

Our evidence

The regulators' objectives, accountability arrangements and forecast costs for 2013-14	Changes in how the FCA and PRA regulate	Changing approaches to skills and information	How the regulators are measuring their performance
Semi-structured interviews with regulators' management and staff to understand their objectives, accountability arrangements and cost forecasts. Review of relevant documentation including formal coordination mechanisms; regulators' cost forecasts for 2013-14.	Semi-structured interviews with the regulators' staff. Obtaining the views of firms and industry representatives through semi-structured interviews and through a small survey in December 2013. Undertaking a case study of authorisations to understand how the changing approaches and processes work in practice. Analysis of times taken by the regulators to process authorisations.	Semi-structured interviews with the regulators' staff. Review of regulators' documentation on staffing matters, including staff turnover. Focus groups with FCA supervisors. Analysis of PRA staff feedback. Undertaking a case study of regulatory data requests to understand the new approaches to data governance and management.	Semi-structured interviews with the regulators' staff on how they measure performance. Reviewing each regulator's management information on performance. Analysing the end-to-end nature and internal consistency of each regulator's performance measurement approach.

Our conclusions

Our key findings are set out in paragraphs 5 to 14.

Appendix Two

Our evidence basis

1 Our independent conclusions on the FCA and the PRA were reached following analysis of the evidence gathered between September 2013 and January 2014. Our audit approach is outlined in Appendix One.

2 We undertook the following study methods:

- We conducted semi-structured interviews with the FCA and the PRA at various levels, from senior management to supervisors.
- We reviewed and analysed published reports and documents of the regulators and third parties, and unpublished documents of the regulators, across a wide range of the regulators' activities. These included reports on surveys of supervisors conducted by the PRA.
- We analysed the regulators' data on authorisation case processing times and performance against service standards.
- We conducted focus groups with FCA supervisors, and spent a day with authorisation teams at both regulators, to understand how the changing approaches and processes work in practice.
- We undertook two case studies on authorisations and on data requests for various purposes, including reviewing how the regulators coordinate in practice.
- We obtained views on the changing regulatory approaches from firms and industry representatives through semi-structured interviews and through a small survey of firms and industry representatives in December 2013.
- We appointed a focus group of sector experts to develop our understanding of issues in financial services regulation. The focus group was not involved in developing our findings, writing the report or forming our recommendations. The focus group consisted of:
  - Michael Foot, Promontory Financial Group (UK) Ltd
  - Brooke Masters, Companies Editor, Financial Times
  - Professor Julia Black, London School of Economics and Political Science
  - Laurie Adams, Non-Executive Director, Principality Building Society
  - Margaret Bloom, Visiting Professor, King's College London
  - Doug Taylor, independent consumer advocate/expert

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