

Regulatory reform

Operating ‘twin peaks’ and the move towards legal cutover (LCO)

On 1 April 2012, the Financial Services Authority (FSA) was restructured internally into a ‘twin peaks’ model in preparation for legal cutover, and on 1 April 2013 the FSA ceased to exist and was replaced with the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Resources were re-aligned and processes changed in both prudential business unit (PBU) and conduct business unit (CBU) supervision to implement the distinct approaches and to allow the PBU and CBU to take forward their own supervisory priorities in an independent but co-ordinated manner. The FSA implemented the process changes required for the authorisation of firms regulated by the FCA and PRA from December 2012.

This ‘twin peaks’ structure enabled the FSA to test, improve and implement the design of the PRA and FCA supervision operating models in preparation for legal cutover. It also allowed PBU and CBU staff to focus more explicitly on their respective prudential and conduct supervision priorities, and to test the coordination arrangements needed when the PRA and FCA came into effect. During the year the FSA adapted and improved some aspects of the new arrangements to support an orderly and progressive approach to the new regulatory system. The adaptations ranged from building and developing relationships and key contacts between the PBU and CBU to support the model for cooperation and coordination to clarifying and developing the new supervision processes and framework, including joint panels and the risk tolerance for each organisation.

The FSA also communicated with firms to explain what the changes would mean for them, including, where relevant, the details of their key supervisory contacts. Operating under Internal Twin Peaks allowed firms to become familiar with some of the differences involved in dealing with two independent regulators and to consider changes they may have to make to the way in which they manage their regulatory relationships. Acting on feedback from firms, the CBU and PBU sought to ensure that the regulatory regime is proportionate and co-ordinated, and clear on what is expected from firms.

Other preparatory work

The FSA also undertook further preparatory work ahead of the change to a new regulatory structure. The Financial Services Act 2012 received Royal Assent in December 2012 and confirmed the date of legal cutover as 1 April 2013, broadly in line with expectations at the beginning of the planning period. Preparations were completed on time and within budget, ensuring a smooth operational transition. A range of Memoranda of Understanding (MoU) were drafted and agreed between the new regulators and other relevant parties.

To achieve this the FSA worked closely with the Bank of England (BoE) to ensure a smooth transition of people, data and assets to the BoE and PRA, with physical moves of over 1,000

staff taking place between January and March 2013. Twenty-four technology systems were copied from the FSA to the PRA for ongoing use beyond legal cutover. Four systems requiring data sharing and continued usage by the FCA and PRA were identified and a link was set up between the two organisations to allow access in a cost-effective manner.

Extensive work was also undertaken to prepare for the FCA, including building a new website and intranet, rebranding buildings and systems, and changing processes to comply with the new legislation.

Staff also received training in the changed regulatory processes.

Cooperation and coordination

During 2012/13, the FSA worked closely with the BoE to develop and finalise the statutory MoU including the FCA/PRA MoU, With-Profits MoU, and BoE/PRA/FCA MoU on Recognised Bodies. Supporting documentation, including operating manuals and service level agreements were also developed. These documents are designed to underpin the relationship between the regulators. The documents take into account lessons from Internal Twin Peaks and, for published MoU, feedback from external stakeholders.

Authorisation of dual-regulated firms

Dual-regulated firms that apply for regulatory authorisation are subject to a conduct assessment by the FCA and a prudential assessment by the PRA at the regulatory gateway. CBU and PBU colleagues worked closely to design a process that minimises the burden on the applicant so their application is managed through a single administrative process rather than separate applications to each regulatory authority. This included developing fully updated process manuals for both conduct and prudential staff for all authorisations processes to prepare for consistent dual regulation. The processes were tested in a live environment from December 2012 when Authorisations Internal Twin Peaks was implemented. This meant coordinating the approach to assessing the conduct and prudential aspects of each application.

Approved Persons – development of FCA/PRA regime

The Approved Persons regime is an important regulatory tool, employed to ensure not only that the right individuals are appointed at the approval stage but that the regulator remains satisfied that they are fulfilling their responsibilities throughout their life as approved persons.

In October 2008, the FSA implemented an enhanced process for approval of Significant Influence Function (SIF) holders within higher impact firms. The main effect of this focus was to introduce a more robust approach to the fitness and propriety of individuals put forward for such positions. The aim was to have a process that conducts high quality assessments of those individuals who are genuinely in a position to put FSA objectives at risk. This includes the chairman; the senior independent director; the chair of the risk and audit committee; the CEO; the finance director and the chief risk officer, with others judged on a firm-specific basis. Such assessments typically involved formal interviews conducted by senior members of the regulator and the FSA's Senior Advisers. An internal review of this process was undertaken in April 2012

to ensure that decisions to interview a candidate were robustly risk-focused and in line with PBU/CBU objectives. This resulted in a re-focusing of efforts and a reduction in the overall number of SIF interviews.

In designing the Approved Persons regime for the new regulatory regime, the focus was on delivering the changes that are required to implement the Financial Services Act 2012. Both the PRA and FCA will continue to keep the regime under review and in particular to take into account any recommendations resulting from the Parliamentary Commission on Banking Standards.

Improving authorisations processes

In February 2013 the FSA also completed the first stage of a work programme to improve all authorisations processes, involving stripping out inefficiencies and automating low-value activities, allowing more time to be spent on higher risk, complex cases.

Barriers to entry report

On 25 March 2013 the FSA and the BoE jointly published a report containing the findings of their review of the requirements for firms entering or expanding in the banking sector. The review was requested in the Treasury's White Paper response to the reports by the Office of Fair Trading (OFT) and the Independent Commission on Banking (ICB) in June 2012 on competition and barriers to entry in the banking sector. The purpose of the review was to ensure requirements are proportionate and not unnecessarily burdensome for new and potential bank entrants, as well as banks looking to expand their activities.

The review covered the capital and liquidity prudential requirements and conduct rules for new banks as well as the authorisation process itself. It involved both internal and external consultations, including firms, overseas regulators and industry advisors and consultants, individually and via industry roundtables. The conclusions of the review have resulted in some significant and far-reaching changes that will have a positive impact for new bank applicants. They include:

- a clearer and more efficient authorisation process;
- two routes to authorisation, depending on the firm's circumstances;
- one of the authorisations routes includes a reduction in the initial information requested in the application, followed by bespoke additional information requests;
- no automatic liquidity premium because a bank is new; and
- significant capital reductions at authorisation for new banks judged to be resolvable with no systemic impact, with up to five years to build up to the level of their peers.

The Conduct Standards remained unchanged as they were not considered to pose barriers to entry to new entrants. This also ensured that consumers continue to be protected while encouraging new entrants to the banking sector.

These changes will be carried forward by the PRA and FCA as appropriate.

Building the PRA

The PRA's objectives

As part of the preparations for the PRA, the FSA worked with the BoE to establish how the PRA would meet its new objectives. The Financial Services Act 2012 gives the PRA two statutory objectives:

- To promote the safety and soundness of all the firms it supervises; this involves firms having resilience against failure and avoiding harm resulting from disruption to the continuity of financial services provision. In promoting safety and soundness, the PRA will be required to focus primarily on the harm that firms can cause to the stability of the UK financial system.
- And, specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are, or may become, policyholders.

The PRA will advance its objectives through regulation, by setting standards or policies that it expects firms to meet; and supervision, by assessing the risks that firms pose to the PRA's objectives in the context of these policies and taking actions, where necessary, to reduce them. The PRA's approach to regulation and supervision will have three defining characteristics:

- a judgement-based approach – in determining whether financial firms are safe and sound and whether insurers provide appropriate protection for policyholders;
- a forward-looking approach – assessing firms not just against current risks, but also against those that could plausibly arise in the future; and
- a focused approach – concentrating on those issues and firms that pose the greatest risk to the stability of the UK financial system and to policyholders.

In October 2012, the FSA and the BoE published two documents setting out the PRA's approach to banking and insurance supervision. These documents were re-issued at legal cutover by the PRA, having taken into account subsequent legislative developments and feedback received.

The FSA undertook extensive work within the PBU to put in place the policies, structures and processes to enable the PRA to deliver on its new objectives. The PRA's new governance arrangements were also established, including the creation of the PRA Board, which held its first meeting on 7 March 2013.

Becoming part of the Bank of England

Practical preparations to create the PRA and enable it to operate as part of the BoE were also completed in time for legal cutover. The BoE's central services functions, including Communications, Finance, HR, Internal Audit, IT and Legal, were scaled up to provide support for the PRA. Systems and processes were adapted as necessary to deliver services to PRA staff, including IT and data supporting supervisory processes. Joint teams from the BoE and PBU were established and a joint governance structure was put in place in the form of project boards reporting to the Transition Programme Board, chaired by Andrew Bailey.

The PRA is based at 20 Moorgate, London. Moorgate was selected following a review by the BoE's Court of Directors, which considered the costs and benefits of locating the PRA in the City of London and the importance of the physical proximity of the PRA to the BoE. This proximity

will facilitate the integration of the PRA to the BoE's policy and operational functions, and ensure the PRA can draw on the BoE's central services in an efficient and effective manner.

In early 2013, staff moved to both the PRA building on Moorgate and the BoE's Threadneedle Street office from the FSA offices in Canary Wharf. Over a three month period, more than 1,000 people were moved with minimal disruption to business-as-usual at either the FSA or the BoE. As part of this process, transferring staff received induction and training into BoE policies, processes and systems to support their integration into the BoE. Interim solutions were developed while part of the FSA operated from the BoE's premises at the start of the year.

ICB proposals

Over the last year, the Government developed its proposals for financial services reform based on the recommendations of the ICB. In February 2013, the Government introduced the Financial Services (Banking Reform) Bill into Parliament. This followed pre-legislative scrutiny of the draft Bill by the Parliamentary Commission on Banking Standards. The Bill, as introduced into Parliament:

- introduces ring-fencing of core retail activities from investment banking activities within large banking groups;
- requires the PRA to exercise its general functions so far as reasonably possible in a way that seeks to minimise disruption to the continuity of the provision of core financial services in the UK;
- specifies the areas for future PRA rule-making to ensure, as far as reasonably practicable, the integrity of the ring-fence; and
- enables the Treasury to specify loss-absorbency requirements as envisaged by the ICB.

As well as assisting the Treasury throughout the policy development process, the FSA also provided both written and oral evidence to the Parliamentary Commission on Banking Standards to assist them in their scrutiny of the draft Financial Services (Banking Reform) Bill. In line with the White Paper response to the ICB proposals the FSA produced a review, jointly with the BoE, into barriers to entry, expansion and exit in retail banking. Further details on the work on barriers to entry can be found on page 13.

The FSA also supported the Treasury in its European negotiations of the relevant directives to ensure that the ICB's other recommendations can be fulfilled, such as higher capital buffers and a bail-in resolution power.

Northern Irish Credit Unions

Regulatory responsibility for all Northern Ireland Credit Unions was transferred to the FSA as planned on 31 March 2012. Since transfer, a proportionate approach was applied to their supervision and the FSA proactively engaged with the largest credit unions.

Regarding the Northern Irish Credit Unions' annual returns for the year-end September 2012, the level of Single Customer View compliance was found to be high, owing to their good quality records and organisational abilities.

Building the FCA

As part of the preparations for the FCA consideration was given to how the FCA would meet its new objectives. The Financial Services Act 2012 gives the FCA one strategic objective of ensuring the relevant markets function well and three operational objectives:

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

The FCA will advance its objectives through regulation, by setting standards or policies that it expects firms to meet, by promoting competition where it will deliver innovation and choice to consumers, and through supervision by assessing the risks that firms pose to the FCA's objectives in the context of these policies and taking actions, where necessary, to reduce them. The FCA's approach to regulation will have three defining characteristics:

- a forward-looking approach – to identify and tackle problems that risk harming consumers or the integrity of markets earlier, including their underlying causes;
- a judgement based approach – focused on achieving the right outcomes rather than just following a process; and
- a pre-emptive approach – to intervene earlier and take meaningful action when we see problems and before they cause consumer detriment or damage to market integrity.

Judgement led approach to Supervision

During the year the FSA continued to develop a more forward-looking, pre-emptive approach to conduct supervision. This means identifying problems at firms and risks to consumers before they occur and result in actual detriment. In order to do this, it is necessary to make judgements about some key aspects of how a firm is run and the risks this poses as a result. In particular, there is a focus on a firm's business model and forward looking strategy, and the way its culture affects the way the firm operates and treats its customers. Regulatory intervention occurs if there are unacceptable risks to the fair treatment of customers or to the integrity of the market.

The FCA's competition objective

The Financial Services Act 2012 gives the FCA an objective to promote effective competition in the interests of consumers, as well as continuing the FSA's duty to do so when exercising general functions (making rules, guidance, codes and internal procedures). Together the objective and duty provide the FCA with a strong, pro-competition mandate. In 2012/13 the FSA developed the FCA's future approach and thinking so that it was ready to advance its competition objective and competition duty from inception.

This work also included developing skills and expertise in competition in preparation for the new organisation. A new Director for the Policy, Risk and Research Division was recruited, with significant previous experience of competition regulation, to lead the development of the FCA's new competition department. The recruitment process for key personnel for the new Competition Department, including a Director of Competition, was also started.

Competition – Market studies

On 19 December 2012, the FSA announced that it had commenced a study to assess how competition works in the markets for General Insurance add-on products. The study looks at whether there are common features of those markets that weaken competition, drive recurring poor consumer outcomes and allow firms to make persistently high profits. Add-on insurance cover is often sold in conjunction with selling another, more valuable product, such as an insurance contract or financial service. Following a scoping exercise, consumer and firm research was carried out in February and March. The first phase of the project, the problem identification and assessment stage, is due to be completed by the end of the third quarter of 2013.

FSA and competition

While the FCA has an objective to promote effective competition, the FSA was required to have regard to competition when making rules, codes, general guidance and general policy in pursuit of its regulatory objectives (consumer protection, market confidence, financial stability and reducing financial crime). Specifically, the FSA was required to have regard to: the need to minimise adverse effects on competition, and the desirability of facilitating competition.

Aside from pursuing and enforcing against non-compliance with rules, the FSA mostly addressed market failures such as information problems and negative externalities.

Relationship with the OFT

The FSA cooperated with the OFT on the basis of the 2009 MoU. Through participation in workshops, regular meetings between the CEOs, working-level meetings between the relevant teams and other communications, the two organisations informed each other's thinking on a variety of areas.

Consumer credit

The Government confirmed its proposal to transfer responsibility for consumer credit regulation from the OFT to the FCA in April 2014. In preparation for this transfer the FSA worked with consumer bodies, the industry and Government to develop proposals for effective regulation that helps the market work well and seeks to ensure the fair treatment of consumers. The FSA published proposals for the new regime in March 2013. This was the first consultation and provided an outline of the proposed regime including a high level approach to authorisation, conduct standards, supervision, reporting and other areas.

The programme of work to deliver the regime transfer within relatively tight timelines includes a number of operational challenges including:

- delivering clear and effective communications to around 40,000 firms affected by the transfer, their trade associations, consumer groups and other key stakeholders;
- ensuring relevant system build and readiness to facilitate interim permission registrations, full authorisations and associated supervisory activities;
- the migration of OFT staff; business readiness to operate the regime; and
- delivering the various activities within the broader headcount constraints described in the FCA's 2013/14 *Business Plan*.

Consumer Credit Programme – Authorisations

The transfer of Consumer Credit regulation may require an estimated 38,000 firms to receive interim permission by 1 April 2014 and 32,500 firms to apply for authorisation or extending their existing permissions between September 2014 and April 2016.

The FSA developed processes, target operating models, business requirements and people/cost models to underpin and prepare for both the interim permission phase and the authorisation phase of the programme, from both a regulatory transaction and contact perspective. It also began engaging with the OFT regarding its existing processes, people and systems. The first Consultation Paper was issued on 7 March 2013, which provided an outline of the regime, including high-level approach to authorisation, conduct standards, supervision, reporting and other areas. The consultation also outlines a future approach to risk appetite and categorisation of consumer credit firms, and the approach to interim permission and authorisation.

Interim permission is designed to ensure that OFT-licensed firms that wish to can continue carrying on their credit activities after 1 April 2014 by confirming key details of their OFT licence online and paying a one-off fee. Interim permission will expire by April 2016, so firms must have applied for authorisation before this date to continue regulated consumer credit activities.

For the authorisation phase, the FSA established two defined groups within the population of consumer credit firms in line with a proportionate, risk-based approach. It identified where firms carrying on certain consumer credit activities are less likely to cause harm to consumers – these firms will have different, less intrusive authorisation requirements and will therefore be subject to a ‘limited permission’ regime.

Process review for mutuals registration and Authorisations

The FSA performed the role of registrar for all mutual societies: Building Societies, Credit Unions, Friendly Societies and Industrial & Provident Societies. As registrar the regulator is responsible for registering these legal entities and ensuring any changes to their details on the Registry are not contrary to the appropriate legislation or the society’s rules. The regulator also receives the societies’ annual accounts and returns, making this and other information available to the public upon request.

The FSA reviewed how the delivery of functions to mutual societies and the public could be improved. This included considering how to improve the functionality of internal case management systems and the external facing mutuals public register. The review also looked at how registrar functions are carried out. Some of the high volume low valued-added processes will be automated, to create more capacity for the mutual areas where value can be added. The interaction between the registrar, societies and the public was also reviewed, to make contact with the regulator easier and quicker.