Chief Executive's report

John Tiner, FSA Chief Executive

Introduction

For the last several years we have set our strategy and arranged our priorities to achieve our three aims of: promoting efficient, orderly and fair markets; helping retail consumers achieve a fair deal; and improving our own business capability. While our direction of travel during 2006/07 has been similar to the previous three years, we have consciously worked to increase the pace of delivery in a number of important areas.

Strategy

Moving towards more principles-based regulation

I believe the benefits of a more principles-based approach are clear: a more responsive, more enduring regime focused on outcomes, giving firms the flexibility to innovate and compete and at the same time be better attuned to their customers' needs. Throughout the last year we have been working hard – including with our stakeholders – to articulate what a more principles-based regime means and to identify the benefits, challenges and the actions needed to get there. Whilst this is a journey that will take time and commitment both from us and from the industry, we have already taken substantial steps in the last year to make this philosophy a reality.

Specifically, we have:

- reduced the size of the Handbook by almost 1,000 pages;
- introduced principles for life insurers to help them calculate their capital on a risk basis, releasing some £4bn of regulatory capital in the UK life insurance industry;
- shifted the focus of our anti-money laundering guidance to outcomes instead of prescription, replacing 57 pages of rules with two pages of principles, supported by useful industry guidance;
- consulted on removing around half the content of the old conduct of business rulebook for investment business, the end result of which will be a new, substantially shorter, conduct of business rule book; and
- removed some detailed requirements that imposed disproportionate costs on firms without commensurate benefits, such as the requirement for small firms to have an external auditor.

Our move towards a more principles-based approach is fully in line with the wider Better Regulation agenda and we published our own Better Regulation Action Plan Progress Report last year. Our Report was informed by three studies on the impact of regulation on the financial services industry, which provided valuable information on the costs and benefits of regulation. Encouragingly, the studies showed that much of what regulation requires is regarded by firms as good business practice. Most of the rules identified as imposing the highest incremental costs were already under review by the FSA, and in December 2006 we published a Simplification Plan in which we committed to new work in a small number of additional areas, such as the client asset rules. By the end of 2008 we expect to have reviewed rules giving rise to over 80% of the administrative regulatory costs identified in our studies.

The Practitioner Panel biennial survey highlighted some concerns about the costs of regulation and, in particular, the burden on small firms. I believe that we have been addressing and are continuing to address these concerns through a variety of measures, including improving our approach to communicating with smaller firms, which I touch on below. Encouragingly, the survey showed that most firms welcome principles-based regulation.

Investing in our people and our infrastructure to improve standards

In order to achieve all the benefits of a more principles-based approach, we need to improve our internal capability and we have made good progress over the last year.

People remain central to the success of the FSA and in tough market conditions we have been able to both attract talent to and retain talent within the organisation. This will remain a significant challenge for us. In particular, we have continued to grow our graduate programme and were delighted to enter *The Times Top 100 Graduate Employers* at 93rd place. Turnover has remained manageable at around 11%, which is less than the financial services average. We also continue to improve both the scale and intensity of our learning and development work. All this has contributed to high levels of employee engagement (as measured by our annual staff survey). We compare favourably with other high-performing organisations in the majority of areas.

Knowledge management capability to support the work our people do will also be central to our success in delivering a more principles-based approach. Over the year we have been working on bringing our IT infrastructure and development activities to industry standard. We have now outsourced both, which will enable us to create the more flexible, productive and low-cost technology platform that we need to support our business and to meet our IT goal of being in line with the best in class by September 2008.

Risk-based regulation

A complement to principles-based regulation is our risk-based approach. The full implementation of our revised risk assessment framework – ARROW II – has enabled us to take a broader view of risk in firms. Our conversations with the senior management of firms are now focused on the key risks and the outcomes we would like to see. For the 1,300 firms which we relationship manage, we have also set out what they should expect from their relationship manager. I, and members of my senior management team, have been conducting one-on-one meetings with relationship-managed firms in order to get feedback on whether we are delivering on these commitments. Feedback so far has been positive, with firms welcoming the transparency of the process. Where we or firms have identified areas for improvement, we have taken action, for example by increasing training for supervisors on both technical matters and relationship management skills.

We recognise that smaller firms can find it harder to establish which regulatory requirements apply to them and over the last year we have developed more ways to help them. Over 2,500 firms have attended our free roadshows and a further 1,800 have attended industry training courses for small retail firms. We have also streamlined our communication with these firms to reduce the amount of information they need to digest. We ran our first formal customer satisfaction survey for both the Firm and Consumer Contact Centres, following earlier pilot studies, and the results have been set as the baseline for future studies. The results showed significant improvements in levels of customer satisfaction, and are now in line with industry standards. We are actively addressing areas where further improvements can be made.

Helping consumers get a fair deal

We continue to see problems in some areas of the retail market. The frequency with which we find examples of poor practice reflects some inherent and structural difficulties within the retail market. These are problems we and industry are working to overcome. We have committed a significant amount of resource in firm-specific supervision and thematic reviews to identifying and addressing these problems, for example in the selling process around PPI, where we still see weaknesses. In order to address the broader, structural issues in the retail investment market we launched our retail distribution review. In this review, we are working with industry, consumer and professional bodies to identify market solutions to these problems.

I would highlight two specific areas where, through our intervention, we have been able to secure effective and timely outcomes for consumers. First, we looked at whether terms related to mortgage exit administration fees might be unfair. As a result, we issued a statement of good practice, which we agreed with the trade body for mortgage lenders. We expect that the measures outlined in this statement will protect borrowers from being surprised by unexpected increases in these fees. Second, Fund Distribution Limited (FDL) made its final payment to around 24,000 investors who made losses in the split capital sector. The company successfully dealt with around 40,000 applications and distributed in excess of £140m. The company has now been wound up, having distributed all its assets, which is a real achievement in a two-year period.

Treating customers fairly

Treating customers fairly is an important example of principles-based regulation. We have set out six key outcomes for retail consumers which we want the industry to achieve. Our overall aim is that all firms treat their customers fairly in all parts of their business and throughout what we call the product life-cycle – product design, marketing and promotion, sales and advice, after-sales information, and complaints handling. We set out the targets we expected firms to reach by the end of March 2007. Progress towards these targets has been mixed, with over 90% of major retail firms meeting the deadline compared with just over 40% of smaller firms. We have been encouraged by the commitment of management to get to grips with the TCF principle, but the patchy performance in making real changes to the way they deal with customers shows that more effort from both the industry and us is still needed. One particularly complex area where we have made progress is in distinguishing between responsibilities to the end customer of product providers and distributors.

Financial capability

Helping consumers help themselves is a key part of our approach to helping retail consumers achieve a fair deal. In my first speech on becoming Chief Executive I announced that the FSA would establish and lead a National Strategy for Financial Capability. Since then, firm foundations have been laid and this year has produced a step change in delivery on the ground and seen us start to make a real impact in people's lives. For example, our funding of the Personal Finance Education Group (pfeg) has enabled them to support over 600 schools through the Learning Money Matters programme, working with the grain of education, to provide schools with the resources and support they need to plan and teach personal finance education. We have distributed over 200,000 packs of educational material and delivered seminars to around 9,000 employees in workplaces across the country. Underpinning all of our consumer information is our consumer website, which we re-launched in January 2007.

There is, of course, much more to do, but the momentum is with us and I am delighted that financial capability has become a public policy priority, both here in the UK and internationally. In this context, I welcome the publication in January of the government's long-term approach to financial capability and, in particular, the leadership of Ed Balls on behalf of the government. The government also announced an independent feasibility study to deliver a national approach to generic financial advice. I believe the provision of generic money advice is a key missing component in helping consumers become more financially capable, and I am delighted that Otto Thoreson has been appointed by the government to do this work.

I believe that lack of financial capability is a key challenge for society. To this end, we have increased our funding from £9.7m in 2005/06 to £17.1m in 2006/07 and we plan to spend some £80m over the remaining four years of our current programme. It will take a generation for this initiative to take full effect, so the FSA and our partners are in this for the long haul. In doing so, we will build on what I believe has been a very promising start.

Increasing transparency and efficiency in wholesale markets

Whilst the external environment has remained relatively calm, we have been addressing a number of operational and structural issues which give rise to actual or potential market failures in wholesale markets. Where possible, we have used market solutions to effect change rather than adding new areas of rules to the Handbook, and there have been some notable successes in the last year.

We have been working with the industry and the other major international regulators to improve back-office standards in confirmation practices (originally in credit derivatives but now across a wider range of derivatives markets). The industry has responded positively, agreeing to targets for the completion of relevant documentation, metrics to measure progress, and initiatives to improve documentation standards. As a result, the backlog of confirmations in credit derivatives has been reduced by 90%.

Last year also saw the general insurance industry achieve the target I set in December 2004 for over 85% of contracts to meet the market-endorsed contract certainty standard within two years. In fact the actual performance by December 2006 was well in excess of this target. The improved procedures and changed behaviours that support the market's solution have reduced the risks and market inefficiency that insurers, brokers and insurance buyers had been exposed to. The drive to achieve contract certainty has also served as a catalyst for the ongoing wider reform of the industry and will further raise the competitiveness of the UK industry.

Tackling market abuse is one of the highest priorities in our work to maintain clean, fair and orderly markets and to maintain confidence in the UK's markets. Whilst we have had a number of successful cases over the last year, we recognise that we need to do more. The challenges of tackling market abuse are significant, and during the year we signed a contract for the development of new systems which will materially improve our ability to monitor transactions across different markets. At £25m this will be the FSA's largest IT project.

In our supervisory activity, we continue to be particularly focused on the fast-growing segments of the markets such as hedge funds, and an emerging area of focus has been increasing our engagement with and understanding of the private equity sector, particularly in view of the rapid growth of the market. The growing movement of capital from the public to the private equity market over the last few years poses challenges for all regulators, and we have been engaging with the industry to make sure we adopt an approach which maintains a balance between capital market efficiency and sufficient regulation to maintain market confidence. We have been particularly keen to better understand the risks related to the use of debt in private equity transactions and the subsequent dispersion of risk through the credit derivatives market.

International work

Given the increasingly international nature and structure of financial services the international agenda remains a very high priority for us. We have continued to invest significant amounts of time and effort – particularly at senior management level – in influencing the international debate in a targeted way, in both formal, multilateral organisations, and in increasing our bilateral exchanges with other regulators.

Of course, Europe continues to play a pivotal role in shaping the development of the regulatory landscape. Once again this year we have worked hard to steer both the overall style and direction of relevant European legislation and matters of substance on individual initiatives, such as MiFID, the CRD and Solvency 2.

We believe strongly that the Lamfalussy committees (CEBS, CEIOPS and CESR) offer the best prospect of achieving regulatory convergence in the EU on a cost-effective basis. We have been particularly active in pushing forward the frontiers of convergence in areas such as peer review and EU-wide training. We have also taken every opportunity to promote better regulation within the EU institutions, both in general terms and in our comments on specific areas such as mortgages and asset management/UCITS.

We have continued to press hard to ensure that Solvency 2 achieves its aim of providing capital standards for insurers which are fully aligned to the underlying risks. Working with the Treasury, we have been at the forefront of proposing a new approach to the regulation of insurance groups operating across EU borders, based on the principle that the adequacy of risk-based capital should be considered only at the group level and not in each subsidiary. This would better align regulation with the operating and economic substance of a group's business. We recognise that this would also pose formidable challenges for the way in which regulators work with each other.

We have also continued to be active at a global level in groups such as IOSCO, where the FSA led an exercise designed to improve the prioritisation of the organisation's work, and in the Basel Committee of Banking Supervisors and the International Association of Insurance Supervisors. We have maintained a close dialogue with a number of our regulatory counterparts across the globe. In particular, we have stepped up our discussions with the United States SEC on a range of capital markets and exchanges issues. We have also collaborated with the SEC and the Federal Reserve Bank of New York on our supervision and policy approach to hedge funds.

Enforcement

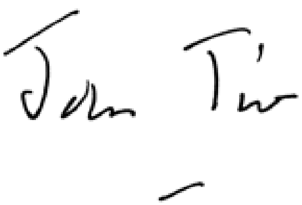
Last year we continued to use the Enforcement tool to support our strategic priorities, with the aim of changing behaviour and getting a better deal for consumers. Enforcement is aligned with our move to more principles-based regulation. Our successful Enforcement outcomes, some of which were based on principles alone, made a real impact in deterring the types of behaviour which we consider unacceptable.

This year was the first full year of using the executive settlement procedures which were implemented as a result of the Enforcement Process Review. Most firms and individuals are now proactively seeking settlement and a smaller number of cases have progressed to be heard by the Regulatory Decisions Committee. This has allowed us to facilitate prompt redress and remedial action in consumer-related cases, get messages out to the industry, and focus our resources efficiently and effectively.

Improving our business capability and effectiveness

Improving the quality of our infrastructure and of our people has helped to enhance the service we offer to firms, consumers and our other stakeholders. This is highlighted in the results we have published in our performance account. We have improved in all the areas of service that we measure, making it our best year yet. At the same time, we have expanded the number of areas against which we are measuring our performance and set ourselves higher targets in some areas.

In this context, I welcome the value for money review of the FSA by the National Audit Office commissioned by the Treasury. The report was, in general, positive, both about the progress we have made to date and also about the future improvements we outlined in our Business Plan. Of course, the report also identified areas for further improvement. We welcome this input which further strengthens our mandate to progress in the strategic direction we have set.



John Tiner

Closing comments

This is my final report as Chief Executive. My six years at the FSA have been characterised initially by exceedingly tough market conditions and managing the consequences for firms and consumers and then, for the last four years, more benign markets, during which we have been able to build an organisation that I believe is fit to face the future.

I would like to close by thanking Callum and the Board for their support and guidance these past few years and all my colleagues for their commitment and professional approach to their work. I wish them all the very best for the future.