

# THE FINANCIAL CONDUCT AUTHORITY

**APPROACH TO REGULATION** | JUNE 2011





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# Introduction

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This document is designed to set out how the Financial Conduct Authority (FCA), which is currently expected to be established by end-2012, will approach the delivery of its objectives. The document complements HM Treasury's February 2011 consultation document: *A new approach to financial regulation: building a stronger system* and HM Treasury's June 2011 White Paper: *A new approach to financial regulation: the blueprint for reform* and the accompanying draft Bill which lays out the proposed legislative framework.

This document outlines initial thinking which will be further refined in the period between now and end-2012. The FSA is publishing it now in order to inform public debate and facilitate stakeholder engagement. It is also designed to provide input for the pre-legislative scrutiny and parliamentary debate on the Bill.

The FSA would welcome comments, and would ask that you send them to [FCAApproach@fsa.gov.uk](mailto:FCAApproach@fsa.gov.uk) by 1 September 2011. Further information and proposals on the FCA's approach will be published over the coming period.

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# CHAPTER | ONE

# Overview

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- 1.1 Confidence in the financial services sector as a whole is at a low level. Conduct issues since 1990 have been a major factor, particularly the significant instances of widespread mis-selling of financial products to retail consumers. These include personal pensions, mortgage endowment policies, split capital investment trusts and payment protection insurance (PPI). Millions of consumers have suffered detriment on a large-scale and, together, the industry has had to make compensation payments of approximately £15 billion, with most PPI redress still to come. Such outcomes would be regarded as unacceptable in other sectors of the economy. They demonstrate that a new approach to conduct regulation is essential.
  - 1.2 In response to these events the FSA has already, over the last three years, introduced major changes to its approach. In June 2010 the government announced new regulatory arrangements for the future. These include the creation of the Financial Conduct Authority, which will apply a new approach to consumer protection, building on changes already made but taking them still further.

### **The new regulatory architecture**

- 1.3 Under the government's plans, the UK will move to a new model of regulation. The Financial Policy Committee (FPC), within the Bank of England, will be responsible for protecting the stability of the financial system as a whole and macro-prudential regulation. The Prudential Regulation Authority (PRA) will be a subsidiary of the Bank of England, supervising deposit takers, insurers and a small number of significant investment firms.
- 1.4 The FCA will be responsible for regulating conduct in retail and wholesale markets (including both exchange-operated markets and over-the-counter (OTC) dealing); supervising the trading infrastructure that supports those markets<sup>1</sup>; and for the prudential regulation of firms not prudentially regulated by the PRA.

<sup>1</sup> Clearing and settlement infrastructure will be supervised by the Bank of England.

- 1.5 The FCA will have the single strategic objective of protecting and enhancing confidence in the UK financial system and three operational objectives:
- securing an appropriate degree of protection for consumers;
  - promoting efficiency and choice in the market for financial services; and
  - protecting and enhancing the integrity of the UK financial system.

The term ‘consumer’ is a very broad one as proposed in the draft legislation. The various types of consumer whose interests the FCA will seek to protect are set out in Box 1 (page 16).

- 1.6 The FCA will also have a duty to discharge its (general) functions in a way that promotes competition, so far as is compatible with its objectives. It will have a free-standing duty to have regard to the importance of taking action to minimise the extent to which regulated businesses may be used for a purpose connected with financial crime. It must also have regard to six regulatory principles (Chapter 3).
- 1.7 The design of the FCA will need to be framed in an EU and international context. This is particularly important given the growing influence of EU legislation and standards on UK policy-making and supervisory practices. In both consumer protection and securities and markets issues, the FCA will therefore engage early and effectively in EU and international negotiations to influence the outcomes in ways that are consistent with its objectives and philosophy.
- 1.8 The current and future EU agenda has a strong consumer protection focus. In July 2010, Michel Barnier, the European Commissioner responsible for Internal Markets and Services, said:

*“European consumers deserve better. They need reassurance that their savings, investments or insurance policies are protected no matter where in Europe they are based”.*

### **The way forward**

- 1.9 The creation of the FCA provides an opportunity to develop a new approach to conduct regulation, addressing the problems which have beset UK retail financial services for 20 years. The government intends that the FCA will have new powers in product intervention; to direct firms to withdraw or amend mis-leading financial promotions with immediate effect; and to publish the fact that a warning notice in relation to a disciplinary matter has been issued.
- 1.10 A key task will be to ensure that the conduct of participants is compatible with fair and safe markets. The FCA will, therefore, focus more closely on wholesale conduct than the FSA. It will adopt a more issues and sector-based supervisory approach across the 24,500 firms which it will regulate for conduct and prudential purposes. A considerable investment in resources will be needed to deal with these significant supervisory responsibilities.

- 1.11 The government's intention is to establish the FCA as an organisation which will:
- promote good outcomes for consumers, through a differentiated and proportionate approach which takes into consideration the knowledge and financial sophistication of the various types of consumer and which promotes competition, so far as is compatible with its objectives;
  - be more outward-looking and engaged with consumers than the FSA has been, (providing more consumer-oriented and more effective communications) and better informed about their concerns and behaviour where this is relevant to regulatory action;
  - set clear expectations for firms and be clear about what firms can expect from the FCA;
  - intervene earlier to tackle potential risks to consumers and market integrity before they crystallise; and
  - be tougher and bolder, building on and enhancing the FSA's credible deterrence strategy, using its new powers of intervention and enforcement.
- 1.12 This new approach will build on changes which the FSA has already made, or to which the FSA has already signalled commitment:
- over the last four years the FSA has radically changed its approach to enforcement, bringing many more cases and imposing higher penalties for infringement of rules;
  - through the Retail Distribution Review, the FSA has sought to address fundamental structural deficiencies in the market rather than to deal solely with adverse outcomes; and
  - in its revised Conduct Risk Strategy and the Product Intervention Discussion Paper (January 2011), the FSA has proposed that in future it should seek to identify emerging consumer detriment problems at a far earlier stage, and use new tools of intervention to prevent consumer detriment emerging.
- 1.13 The essence of the intended new approach can be illustrated by a specific example. In response to the mis-selling of PPI, the FSA has intervened robustly to secure redress of consumer detriment (see Chapter 5). In future, however, the FCA will be seeking to ensure that fewer such problems develop in the first place.
- 1.14 One consequence will be that the FCA's actions will need to be based on judgemental trade-offs between different, desirable objectives – whether, for instance, to protect some consumers from detriment even if this necessarily restricts choice for others. It will, therefore, be essential for the FCA to consult widely about how it should strike these trade-offs, to explain clearly the basis for its judgements and to be clearly accountable.

### **Culture**

- 1.15 The FCA will aspire to command the respect of consumers and of the firms it regulates. It will establish an organisational culture and behaviour that reflects, and is best equipped to deliver, its new role and wide-ranging responsibilities. The culture will be based on judgement and sound analysis. The FCA will be transparent to external stakeholders, fully acknowledging that openness and transparency can lead to improved consumer outcomes. It will be cooperative not only internally but also

externally with the PRA and with other domestic and international regulators. The FCA will be an organisation that says what it wants and what it means, clearly and succinctly, taking prompt action to achieve its goals.

- 1.16 To do this, the FCA will need to retain and attract professional and dedicated staff, equipped with the skills and knowledge to tackle the difficult issues ahead. It will need to be a dynamic and learning organisation, committed to developing individuals within a career that includes management and specialist paths. It will put a premium on flexibility and team-working where resources are allocated flexibly across the organisation.
- 1.17 It will make a strong commitment, as the FSA has done, to the principles of equality and diversity, recognising the importance of the diversity in its workforce both to the working environment and to the delivery of its functions as a regulator.
- 1.18 It will be essential that the purpose of the FCA is fully understood and supported, from the outset, by the public and Parliament. The FCA needs this support if it is to play its role effectively and to retain high calibre people who will want to work in such an environment.
- 1.19 Central to the FCA's decision-making process will be a senior level, high quality, business and market analysis team. This team will provide the thorough analysis required to understand how markets work and how they interact with consumer behaviour. It will identify the features of industry economics (such as very high returns on particular products) which may indicate or create incentives for actions detrimental to consumer interests. Its analysis will underpin decisions on where and when to intervene and how an intervention will affect the market as a whole, including competition. It will look to build further on the FSA's use of ex-post cost benefit analysis (CBA) to assess the impact of specific regulatory changes. The team will be an important new function which the FSA does not currently have in this form.
- 1.20 The overall direction of travel is now clear. But we have until the end of 2012 to develop our thinking further. The legislative process, beginning with pre-legislative scrutiny, provides an opportunity for Parliament to consider carefully the FCA's appropriate powers and responsibilities. The FSA will use the next 18 months to develop the FCA's operational capability, to build the skills needed and to ensure a smooth transition from the FSA. This document seeks to describe the direction of change, but also to stimulate debate about the details which need to be got right before the FCA begins operation.

**Structure of this document**

1.21 The document is structured as follows:

- Chapter 2 sets out the scope of the FCA;
- Chapter 3 outlines the FCA's objectives and powers, as proposed by the government;
- Chapter 4 explains the regulatory approach which the FCA expects to follow in discharging its responsibilities;
- Chapter 5 outlines how the FCA plans to discharge its various functions, including supervision, policy-making, authorisation, and enforcement;
- Chapter 6 summarises the FCA's plans to coordinate with other regulatory authorities, in the UK and internationally; and
- Chapter 7 sets out the next steps in implementing the FCA's operating model.



CHAPTER | **TWO**

# Scope

- 2.1 The FCA will regulate the conduct of 27,000 firms which carry out a very wide range of business in the retail and wholesale banking, investment, securities and insurance markets. It will also be responsible for the prudential supervision of around 24,500 of those firms. See Tables 1 and 3 below.

**Table 1**

FCA-regulated firms – conduct of business and prudential

<b>Legal entities</b>	<b>Total</b>
Personal investment firms	6,198
Insurance intermediaries	6,246
Mortgage intermediaries	1,640
Investment managers	2,124
Non-deposit taking lenders	137
Corporate finance	452
Wholesale firms	224
Custodians	149
Professional firms	333
Markets (exchanges & infrastructure providers)	27
Collective investment schemes	561
Other (including travel insurance only and media firms)	6,388
Other brokers	2
Managing agents	4
Investment firms	11 <sup>2</sup>
<b>Conduct and Prudential Total</b>	<b>24,496<sup>3</sup></b>

2 A small number of significant 'investment firms' will be designated for prudential supervision by the PRA, and the FCA would be responsible for the conduct-only supervision of those.

3 This total includes EEA branches and EEA service firms.

**Table 2**

FCA firms regulated under other legislation

Legal entities	Total
Electronic money institutions <sup>4</sup>	87
Payment institutions <sup>5</sup>	872
<b>Total</b>	<b>959</b>

**Table 3**

FCA-regulated firms – conduct of business only

Legal entities	Total
Banks	319
Building societies	49
Investment banks	25
Credit unions	652 <sup>6</sup>
Friendly societies	133
Life insurers	193
General insurers	636
Wholesale insurers, commercial insurers & reinsurers	64
Lloyd's & Lloyd's Agents	72
<b>Conduct Only Total</b>	<b>2,143<sup>7</sup></b>

- 2.2 There is a risk, based on past experience, that consumers will not understand the distinction between registration and regulation and the different powers which the FCA will have when acting as a registrar as apposed to a regulator. The FCA will seek to mitigate this risk through clear communication to consumers. This will be done through the public Register of firms and through other channels.
- 2.3 The 27,000 firms provide financial products and services to an extensive set of consumers in the UK and internationally. They cover a broad spectrum, from retail consumers taking out a mortgage or buying a pension through to major corporations raising capital in the international investment markets.
- 2.4 The data below<sup>8</sup> illustrates the scale and diversity of the products and services offered by these firms. For example, in the retail financial services sector:

<sup>4</sup> This total comprises electronic money institutions (EMIs) authorised or registered under the Electronic Money Regulations 2011. The number of incoming EEA-authorised EMIs is not yet available as the change has only just been made.

<sup>5</sup> This total comprises payment institutions (PIs) that are authorised or registered under the Payment Services Regulations 2009 and incoming EEA-authorised PIs.

<sup>6</sup> Of this total, 178 credit unions are based in Northern Ireland and are currently supervised by the Department of Enterprise, Trade and Industry (DETI). Responsibility for the conduct regulation of credit unions in Northern Ireland is expected to transfer from the DETI to the FSA and, subsequently, the FCA.

<sup>7</sup> This total includes EEA branches and EEA service firms.

<sup>8</sup> The source for this data is partly the FSA's regulatory returns but some of the data is sourced from external organisations which are separately acknowledged.

- Each year about 30 million home insurance and 25 million motor insurance policies are bought in the UK.<sup>9</sup> Similarly, nearly 25 million travel insurance policies are bought every year, with annual gross written premia of over £700 million.<sup>10</sup>
- Current data held on seven of the most significant insurance firms (including life, general and composite insurers) indicates that they are responsible for over 60 million UK insurance policies.
- Current data held on the seven largest deposit takers estimates that they have 125 million UK customer accounts.
- In 2008/09 around 8 million households in England owned their property with a mortgage.<sup>11</sup> In 2010 over 500,000 loans for house purchases were issued, with a value of £77.1 billion.<sup>12</sup>
- In the period April 2009 to March 2010 over 2.7 million retail investment products (including pensions, investment bonds, endowment policies and ISAs) were sold in the UK.

2.5 FCA-regulated firms have a significant share of the global market in the wholesale investment, insurance and banking sectors. London is also a major centre for capital-raising by governments and companies in the primary markets and for market trading in bonds, equities and derivatives. The following examples demonstrate the scale of this business:

- London is the leading centre of international bond trading, with an estimated 70% share of secondary market turnover of \$80 trillion in 2009<sup>13</sup>;
- overall trading of UK equities on the London Stock Exchange totalled around £1,194 billion in 2010<sup>14</sup>;
- London had a 17% share of global foreign equity trading in 2009; a 9% share of international Initial Public Offerings by number; a 6% share of global equity market capitalisation; and a 13% share of further issues<sup>15</sup>;
- London is the largest centre in the \$600 trillion global OTC derivatives business with an estimated 46% share of global turnover<sup>16</sup>; and
- London is a leading marketplace in metals and energy derivatives with a 15% share of global exchange trading in commodities.<sup>17</sup>

2.6 Taken together, the FCA's responsibilities will be very wide-ranging. The FCA's conduct and prudential regulation will play a central role in the activities of the general public, the corporate sector, the financial services sector itself and the UK economy as a whole.

2.7 The government has also consulted on the merits of transferring responsibility for consumer credit regulation from the Office of Fair Trading (OFT) to the FCA. It will announce its decision later in the year.

9 Source: GFK Financial FRS.

10 Source: ABI/Mintel.

11 Source: Department of Communities and Local Government.

12 Source: Council of Mortgage Lenders.

13 Source: Bank for International Settlements and CityUK estimates.

14 Source: London Stock Exchange.

15 Source: World Federation of Exchanges.

16 Source: April 2010, Bank for International Settlements.

17 Source: [www.thecityuk.com/media/216938/commodities%20trading%202011.pdf](http://www.thecityuk.com/media/216938/commodities%20trading%202011.pdf)



CHAPTER | **THREE**

# **Objectives and powers**

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- 3.1 The government proposes to give the FCA a single strategic objective – to protect and enhance confidence in the UK financial system. This objective will be completed by three operational objectives:
- securing an appropriate degree of protection for consumers;
  - promoting efficiency and choice in the market for financial services; and
  - protecting and enhancing the integrity of the UK financial system.
- 3.2 The government also proposes that the FCA must, so far as is compatible with its objectives, discharge its general functions in a way which promotes competition. (The FCA’s general functions include rule-making, guidance and general policies.) The FCA will also have a free-standing duty to have regard to the importance of taking action intended to minimise the extent to which regulated businesses may be used for a purpose connected with financial crime (including fraud, dishonesty, and handling the proceeds of crime).
- 3.3 The FCA must also have regard to six regulatory principles, namely:
- the need to use its resources in the most efficient and economic way;
  - proportionality, the principle that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected to result;
  - the general principle that consumers should take responsibility for their decisions;
  - the responsibilities of senior management to comply with the regulatory framework;
  - openness and disclosure, publishing information about regulated persons or requiring them to publish information, which underlines the importance of the FCA making market information available, with appropriate safeguards, to reinforce market discipline; and
  - transparency, that the FCA should exercise its functions as transparently as possible, which recognises the importance of ensuring that appropriate information is provided on regulatory decisions and also that the FCA should be more open and accessible, both to the regulated community and the general public.
- 3.4 As a public sector body, the FCA will have obligations under the Equality Act 2010 to have regard to various matters including the principles of equality, diversity and inclusion in the exercise of its functions. The FCA will continue to find proactive ways to do so, building on the work already done by the FSA.

### The strategic objective: a differentiated approach

- 3.5 In line with its strategic objective, the FCA will aim to protect and enhance confidence in the firms and markets it regulates. It will adopt differentiated approaches to these firms and markets, taking into account the outcomes it seeks to achieve. The FCA will develop a model of regulation that recognises the variety of ways in which different types of firm, product or activity, affect its ability to deliver its objectives, both in individual markets and in the financial services sector as a whole. This approach will recognise that there are important differences between wholesale and retail markets – but also important links that could pose risks to confidence in the UK financial system.
- 3.6 For the purposes of the FCA’s operational objective to secure an appropriate degree of protection for consumers, the term ‘consumer’ is a very broad one – see Box 1. It includes, at one end of the range, infrequent purchasers of retail products, such as a pension or life insurance policy to, at the other, investment banks engaging continuously in more financially sophisticated transactions in the course of their business. The FCA will recognise the differences across this spectrum. However, while financially sophisticated consumers do not require the same degree of protection as retail consumers, high standards of conduct across the board are essential to enhance confidence in the UK financial system.

#### BOX 1: WHAT IS A ‘CONSUMER’?

The government proposes a broad definition of ‘consumer’. The spectrum covers:

- ‘retail’ consumers buying financial products or services for their own use or benefit (e.g. travel insurance, ISAs, or mortgages), either directly or through a regulated firm;
- ‘retail’ investors in financial instruments, for example shares, bonds and exchange traded funds; and
- various kinds of ‘wholesale’ consumers, including:
  - i. regulated firms buying a product or service on behalf of another person (e.g. a bank acquiring travel insurance in bulk in anticipation of selling it on to retail consumers);
  - ii. regulated firms making investments in their capacity as agent or fiduciary (e.g. an investment fund buying shares for their clients or stockbrokers executing orders on behalf of their clients);
  - iii. various types of investors in financial instruments (e.g. hedge funds and day traders);
  - iv. regulated firms trading across markets to manage their own risk or inventory of stock;
  - v. non-regulated corporates (financial firms, governments, public bodies and other institutions), organisations or individuals, in certain circumstances, buying financial products or services for their own use (e.g. the treasury functions of a building society or industrial corporate or municipality seeking to manage their balance sheet or exposure to foreign sources of revenue as well as certain high net worth individuals); and
  - vi. issuers looking to raise capital who may buy services and advice from sponsors and services carried on by investment banks in the course of regulated activities.

The definition includes market infrastructure providers such as the London Stock Exchange.

### **Securing an appropriate degree of protection for consumers**

- 3.7 The operational objective to secure an appropriate degree of protection for consumers, which is similar to the FSA's objective under the current legislation, provides the FCA with a broad remit to protect consumers from actual or potential detriment. The FCA's new powers should provide greater scope to protect and enhance confidence in retail markets.
- 3.8 As noted earlier, the FCA will adopt a differentiated approach to protecting different categories of consumer. Key considerations are reasonable presumptions about:
- the differing degrees of risk involved in different kinds of investment or other transaction;
  - the differing degrees of experience and expertise that different consumers may have;
  - any information which the Money Advice Service, formerly known as the Consumer Financial Education Body, has provided to the FCA in the exercise of the consumer financial education function;
  - any information which the Financial Ombudsman Service (the ombudsman service) has provided to the FCA;
  - the needs that consumers may have for advice and accurate information; and
  - the general principle that consumers should take responsibility for their decisions.
- 3.9 Building on the work of the FSA, the FCA will aim to intervene earlier in retail markets to protect consumers before they suffer direct effects as a result of failures in these markets. This duty to protect retail consumers will necessitate a focus not only on firms' conduct towards them directly, but also on the knock-on effects and adverse implications that may result from activities in retail-related wholesale markets. Chapter 5 gives examples of retail consumer detriment in the past and explains how the FCA plans to learn from, and improve on, the approach adopted by the FSA and predecessor regulators.
- 3.10 A further important way to promote good outcomes for retail consumers is to equip them with information so that they can avoid risks and protect themselves. The FCA will seek to ensure that firms provide appropriate information to consumers, at the right time, about the product or service being purchased, so that they can consider the implications for their personal situation and make an informed decision. Information provided to consumers by the FCA itself, by the Money Advice Service, and by other organisations working to support consumers in their financial decisions will also help. The Financial Services Compensation Scheme (FSCS) also has a role in providing information to consumers about their position if the firm they are dealing with is unable to meet its liabilities.
- 3.11 The draft legislation includes the general principle that consumers should take responsibility for their own decisions. As explained in Chapter 4, the FCA will do more than the FSA has done to engage directly with retail consumers and to explain what they can expect from a regulated firm and from the FCA itself.
- 3.12 In providing appropriate consumer protection, the FCA will also look to use measures that promote competition. In the case of products or services, remedies directly focused on promoting competition – for example, by removing barriers to entry, search or switching – may not improve consumer outcomes because

market power is not always central to the problem. A possible example might be retail consumers' excessive focus on (often irrelevant) past performance in making investment decisions. In other circumstances, where measures that promote competition remedy both market power and information asymmetry, they can provide consumer protection. A good example, in relation to PPI, are measures taken on the bundling of insurance and credit at point of sale.

### **Promoting efficiency and choice in the market for financial services**

- 3.13 This operational objective is closely linked to the FCA's proposed role in promoting competition (Box 2 below). The link arises because competition is a key driver of choice and efficiency in markets. However, conditions in financial services markets are often sub-optimal.
- 3.14 The FCA will, therefore, focus more directly than the FSA has done on the workings of markets, including market power. This will be an important change of emphasis in the new regulatory regime. The FCA will seek to promote competitive markets, both retail and wholesale, where consumers can make an informed choice of products or services.
- 3.15 However, the FCA may also decide that there are some retail markets where consumers cannot exercise informed choice, for example because of structural features, such as consumer behaviours, including powerful biases in their decision-taking which firms can readily exploit. Here, interventions to promote choice will be successful only if the FCA can tackle the underlying characteristics of the market.

#### **BOX 2: COMPETITION**

The government proposes that, in addition to the strategic and operational objectives, the FCA will have a duty to discharge its general functions in a way that promotes competition, insofar as is compatible with its objectives. The government has stated that it is giving the FCA a formal and wide-ranging mandate to place competition at the heart of the new conduct regime. It sees the new duty, combined with the new efficiency and choice objective, as giving the FCA a significant role in promoting competition in financial services.

The FSA is already alive to market failures that are found in the many intermediated wholesale and retail markets in financial services. It is particularly aware of the prevalence of problems arising from information asymmetries. One important effect of the new mandate is that the FCA will need to consider options to strengthen competition where these may be relevant to resolving particular market failures it has identified. Options to strengthen competition are likely to include measures which reduce market power, including measures which affect firms such as reducing barriers to entry or exit, and measures which help consumers make better decisions by helping with search or switching. Measures which improve transparency in markets can combat information asymmetries, although the FCA recognises the limitations of these measures for some consumers.

The FCA will need a sound economic understanding of the way relevant markets operate in order that its regulatory interventions will promote competition and will effectively address the problems identified. This requires an approach to financial services markets that is significantly different to that of the FSA, both analytically and culturally.

**BOX 2: COMPETITION (CONTINUED)**

As one possible example, where the FSA's analysis of an episode of consumer detriment arising from a conflict of interest might focus on redress and on improving conflict management, the FCA will go further. Its approach will also include analysis of whether the problem can be reduced by stronger competition in this or related markets and, if it can, of different ways of achieving that stronger competition.

The government does not propose to give the FCA specific additional competition powers. The FCA will be able to use existing Financial Services and Markets Act (FSMA) powers such as making rules and guidance. It will be able to use firm-specific powers in relation to its market efficiency and choice objectives. The FCA will also have a new mechanism to refer a matter to the OFT for consideration. It will, therefore, work closely with the competition authorities.

**Pricing**

The government has said that the FCA will not be an economic regulator in the sense of prescribing returns for financial products or services. The FCA will, however, be interested in prices because prices and margins can be key indicators of whether a market is competitive. Where its powers allow, the FCA will take into consideration more positively the cost of products or services in making judgements about whether consumers are being fairly treated.

Where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers. This would involve the FCA making judgements about the value for money of products.

The FCA will thus consider exercising its powers to take action where costs or charges are excessive. There are currently rules on excessive charges for mortgage arrears; and the FCA could, for example, re-introduce rules on excessive charges for a wider range of investments. For charges that are unfair or clearly out of line, there is an immediate value to intervention which would not require the FCA to be an economic regulator. The FCA could also consider requiring product providers to show that charges are not at a level that undermines the possibility of consumers achieving a return.

**Protecting and enhancing the integrity of the UK financial system**

- 3.16 The FCA will not have explicit responsibility for financial stability. That will be the responsibility of the Bank of England, the FPC and the PRA. As reflected in its strategic objective, however, and in the fact that its CEO will be a member of the FPC, the FCA's supervision and other regulated activities will be important to the arrangements in the UK for preserving stability. Like the PRA, the FCA will be subject to FPC recommendations and directions on the use of regulatory tools in the pursuit of macro-prudential policy. There will be a continuous exchange of views and information flow between these regulatory bodies.
- 3.17 In pursuing this operational objective, the FCA will be concerned with a number of aspects. These will include: the soundness and resilience of the trading infrastructure; the integrity of the financial markets, including the reliability of their price formation process and suitability of listing rules; combating market abuse; and addressing the extent to which the UK financial system may be used for the purposes of financial crime.

This operational objective will be central to the FCA's supervision of the institutions that provide market infrastructure and the crucial role they play in delivering capital and risk transfer mechanisms and creating confidence in the financial system.

- 3.18 The FCA's regulatory resources relating to the integrity of a market will be concentrated on those markets which have a clear, direct and immediate link to wider confidence in the financial system, because they:
- have a strong connection to the UK economy (e.g. they relate to the price of oil, benchmark interest rate instruments or the securities of major companies); or
  - are a key market for investment by a large number of consumers (e.g. the London Stock Exchange equity market); or
  - are linked into the wider fabric of the financial markets (e.g. derivatives priced and traded on the basis of certain cash markets); or
  - provide an international benchmark (e.g. the London Metal Exchange's metals futures markets).
- 3.19 The FCA will therefore focus its market supervision on all organised trading markets, whether exchanges or multi-lateral trading facilities and on some of the more significant non-organised OTC markets for the trading of financial instruments, capital and risk.

### **Financial crime**

- 3.20 Financial crime threatens both the FCA's consumer protection and integrity objectives. It applies across firm and sector boundaries and can distort information and take advantage of the incentives which drive the behaviour of market participants. It is, therefore, also relevant to the efficiency objective. The FCA will be ready to take action in relation to financial crime risk in any of the sectors or markets it regulates (Chapter 5 gives details).

### **Balancing the FCA's objectives**

- 3.21 The nature of the FCA's objectives means that it will be necessary to balance carefully the expectations of different (and even the same) stakeholders. The FCA will recognise that it will often have to make difficult judgements involving balancing one interest against another.
- 3.22 Examples of such judgements will be:
- The threshold conditions for authorisation aim to protect the financial system and consumers and secure the integrity of the financial system; but barriers to entry could have an impact on competition.
  - Ensuring firms have controls in place to prevent financial crime, such as money laundering, may make access to services more difficult for some consumers.
  - The need to consider the balance between protection and intervention on the one hand, and enhancing choice on the other. Some categories of consumer might favour less consumer protection if this delivered lower pricing and wider choice but at the cost of greater risk.

**What the FCA is *not* responsible for under its objectives**

- 3.23 No regime can ever prevent all conduct or prudential failure. The FCA will work closely (including sharing information) with other key organisations forming part of the regulatory structure, such as the ombudsman service, the FSCS and the Money Advice Service, which carry out important and separate functions. The FCA will not be responsible for handling individual complaints on financial services. The ombudsman service provides individual consumers with a complaint-handling service and the FSCS provides compensation when a firm fails financially (see Chapter 6). Although the FCA will no longer have a requirement to have regard to ‘public awareness’, the FCA will take on the FSA’s existing functions in relation to the Money Advice Service. This service is designed to help people understand financial matters and manage their finances better.
- 3.24 The FCA will not have a statutory responsibility to be an economic regulator, such as Ofcom or other utility regulators.
- 3.25 It would also be impractical, if not impossible, for the FCA to intervene in other areas where it does not have a statutory responsibility. For example, the FCA is not proposing to approve financial service products beyond those authorised at present by the FSA and does not intend to provide kite-marking or product approval.
- 3.26 It will be important for society to understand that the FCA cannot guarantee the return on a product or service which is suitable at the time of purchase and where appropriate information has been made available to the consumer. The FCA will need to communicate this message effectively from the outset.
- 3.27 The FCA will not set social policy as this is a matter for the government. However, as set out in: *A new approach to financial regulation: building a stronger system* (February 2011), the government has acknowledged that financial inclusion is an important issue to address and that the FCA has a mandate to do so under its efficiency and choice objective.
- 3.28 An example, in the case of the FSA, has been its preparedness to authorise a number of Sharia-compliant banks, both wholesale and retail. The FSA was able to do so without relaxing its criteria for authorisation or prudential standards. On the retail side, it shows that the FSA recognised the possible needs of the Muslim community for access to banking facilities which might otherwise have been unavailable because of their religious beliefs.



CHAPTER | **FOUR**

# **Regulatory approach**

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4.1 As set out in: *A new approach to financial regulation: building a stronger system*, (February 2011), the government expects the FCA to intervene more strongly in retail financial services markets. The proposed new powers, in relation to product intervention and financial promotions, will enable the FCA to act, and be seen to act, more swiftly to prevent retail consumer detriment. It is equally clear that in other areas the government is not looking for a major change in approach. One example is the regulation of capital markets where the intention is to carry over many of the FSA's existing responsibilities to the FCA.

4.2 The main elements of the FCA's approach will be as follows:

#### **Preventative action**

4.3 The FCA will be ready to intervene in relation to the operation of markets for financial products and services where there is evidence that these are not operating in the interests of retail consumers or the wider economy. The FCA will also be more ready to intervene, making full use of its powers, to tackle potential and emerging risks to consumer protection and market integrity before they materialise, and in order to prevent large-scale detriment.

4.4 The FCA will intervene early in relation to products where the risks are likely to outweigh the benefits the products will bring, considering factors such as the number of consumers and the amount of potential loss. The FSA has already proposed a new and intrusive approach to the way firms bring financial services products to the retail market. The FCA will look to build on this approach.

4.5 The FCA will also intervene where the product may be well known and of utility to consumers but the sales and distribution process of a firm does not meet regulatory standards and consumer detriment is occurring. Where the FSA has typically allowed firms to continue to market and sell products alongside programmes to remedy poor practices, the FCA may not. When the firm is a major supplier of a product which is commonly sold to consumers, the consequences of such action, which could disrupt consumer choice or access, will be weighed against the benefits of preventing further consumer detriment. While this would be new in the UK, other regulators have taken this approach. In 2009, for example, the Japanese Financial Services Agency banned a firm from advertising or selling retail products for a month.

**Causes and symptoms**

- 4.6 The FCA will aim to shift the balance towards tackling the root causes of problems, not just the symptoms. The traditional focus on firm conduct at the point of sale has limitations. In particular, when poor conduct is discovered, detriment has already occurred. If this is on a significant scale, market confidence can be damaged. In retail markets in particular there can be opportunities for firms to exploit consumer behaviour such as lack of confidence or knowledge. Firms may seek to increase revenues to preserve return on capital at the expense of treating customers fairly. There may be incentive structures driven by sales targets rather than outcomes for consumers. These opportunities can be magnified where competition is not effective.
- 4.7 If the FCA can address the root causes, at least some of the poor outcomes for consumers should be prevented. Drawing on the work of the new business and market analysis team and analysis of business models, the FCA will base its regulatory interventions on a deeper understanding of underlying commercial and behavioural drivers and the often multiple causes of poor outcomes for consumers. This will involve analysis of often complex chains of interaction. It could include reaching up the distribution chain, where appropriate, to intervene in wholesale activity where this could be the source of significant retail detriment. This will fully reflect the FCA's increased focus on promoting competition and in securing the right outcomes for consumers. It will be an important change in regulatory approach.

**Differentiated approach**

- 4.8 The FCA will tailor its approach and the use of its regulatory tools, to the particular risks in the sectors, firms and products which it regulates. The emphasis will be more on thematic work, targeting product services and practices which have the potential to cause consumer or market detriment, than on firm-specific risk. The emphasis, however, will continue to be on intensive, institution-specific supervision for those institutions that individually can cause significant consumer or market detriment. These include major firms and market infrastructure providers.

**Fair and safe markets**

- 4.9 The FCA will intervene proactively to make markets more efficient and resilient, enhancing integrity and choice, taking into account the duty to promote competition. It will ensure that market infrastructure is sound and well-run, with users of markets having confidence in the reliability of the price formation process and that the transactions they enter into will be properly executed and performed. A key task of the FCA will be continuing to ensure that the conduct of market participants is compatible with fair and safe markets. This means not only working to deter market abuse and pursuing it effectively where it does occur but also to prevent other behaviour which would harm confidence in the integrity of markets.

**Engaging with retail consumers**

- 4.10 The FCA will focus on reducing and preventing consumer detriment in the retail sector. It will be committed to a better understanding of consumer behaviour, consumer needs and consumer experiences – for example, through extensive market

research – and to building the consumer perspective into all its work. Building and sustaining effective relationships with consumers and their representatives will promote greater confidence in the FCA's role as a regulator.

- 4.11 The FCA will engage more with consumers directly, including through social media, and through representative bodies at the European level, including those in the UK. It will also rely on roadshows (which have proved very successful in the past), panels, focus groups and other means to ensure direct face-to-face contact. It will collect and analyse consumer information from other sources such as complaints, including those investigated by the ombudsman service, and external commercial, academic and public interest research. The FCA will ensure that its own communications to consumers are clear and readily accessible.
- 4.12 This greater focus on and engagement with consumers will guide the FCA on how to design interventions to work with the grain of consumers' behaviour. Equipping consumers to avoid risks and protect themselves can help to ensure good consumer outcomes. The FCA will work particularly closely with the Money Advice Service in this regard.

#### **Credible deterrence (see Box 3)**

- 4.13 The FCA's more interventionist stance and lower tolerance for consumer detriment is likely to require further enhancement of the FSA's recent strong activity in enforcement. Based on FSA experience of thematic work, a greater use of cross-firm supervision is likely to result in more enforcement cases, and thus a need for greater enforcement resource. The FCA's credible deterrence strategy should be strengthened by the FSA's new penalty framework which provides a stronger link between the benefit a firm receives from its misconduct and the size of the fine. The FCA will continue to work closely with other agencies in this area, including overseas regulators.
- 4.14 In line with the government's policy aim of encouraging greater transparency, the FCA will seek to ensure appropriate information is made public about disciplinary actions at an earlier stage. The government has outlined that it intends to give the FCA the power to publish the fact that a warning notice in respect of enforcement action has been issued, including a summary of the notice. This will result in disciplinary action becoming known at an earlier stage, analogous to criminal and civil proceedings, to improve transparency.
- 4.15 If this provision is enacted, the FCA will need to balance the advantages of openness with the need to respect private rights and due process. In this context, the government has indicated that there will be a requirement to consult the person concerned before issuing any information about the warning notice. This should ensure that account will be taken of, for example, any reputational damage which could occur as a result of publication of the information.

**BOX 3 : CREDIBLE DETERRENCE**

The FSA's credible deterrence strategy is a deliberate strengthening of the enforcement function to achieve better outcomes for consumers and across markets. Under the strategy, the FSA has made full use of its enforcement powers, bringing tough, targeted, public action in areas of risk to its objectives. This has ensured that those who break the law or who do not meet the standards that are rightly expected of them are subject to tough sanctions. The strategy includes:

- higher penalties;
- bringing criminal prosecutions;
- focusing closely on the responsibility of individuals – especially Significant Influence Function holders (see Chapter 5); and
- in the area of consumer protection, holding firms to account for misconduct and requiring them to make good on the losses they cause consumers.

Through a robust use of both its civil regulatory enforcement and criminal prosecution powers, the FSA has achieved significant results in all of these areas in the past few years. Since 2007, it has issued fines in excess of £150 million and prohibited more than 200 individuals from the financial services industry. In the past six months alone, enforcement action has secured redress which is expected to be in excess of £150 million. Ten criminal convictions for insider dealing have been obtained, with sentences of up to three years and four months.

The FCA will build on the FSA's success and maintain the momentum so that markets are cleaner and consumers are treated fairly. It will be ready to utilise new powers provided under the Financial Services Act 2010, including powers to suspend authorised and approved persons; impose penalties on persons that perform controlled functions without approval; both fine an authorised person and withdraw authorisation with respect to the same rule breaches; and publish information about decision notices.

**Transparency and disclosure**

4.16 The FCA's culture will be based on a presumption of transparency, as set out in the six statutory regulatory principles to which the FCA must have regard. Such openness will be important as a way of showing consumers, Parliament, the media and other stakeholders what the regulator is doing. It will be a key element in the FCA's regulation and will be explained further in future publications as well as how this will be implemented. Initial thinking is set out below:

- The FCA will build on the FSA's approach to consultation as part of the rule-making process and will seek to develop more effective ways of getting feedback on proposals, including from consumers and their representatives.
- The FCA will engage actively with the four statutory panels which it will be required to put in place – representing the views of consumers, regulated firms, smaller regulated firms, and market practitioners.
- The FCA will publish more information about its views on markets (key trends, products and services) and the comparative performance of a firm.
- The FCA will recognise that necessary restrictions on disclosure exist in UK and EU law. It will also recognise that it will not always be appropriate for information to be disclosed, for example where the disclosure would be incompatible with the FCA's objectives, or where disclosure could harm a current or intended investigation or inquiry and thus undermine the FCA's ability to perform its core functions.

### Accountability

- 4.17 The FCA will be accountable to government and Parliament. The accountability mechanisms will build on and strengthen the current arrangements for the FSA. The number of such mechanisms will increase and will include:
- A requirement to report annually to government and Parliament on how its actions have accorded with statutory objectives and to hold an annual public meeting. The Treasury Select Committee of the House of Commons is likely to take a close interest in the FCA's performance.
  - Oversight of the FCA's work by a Board, appointed by government, with a majority of non-executive members. Two non-executive members will be appointed jointly by HM Treasury and the Department of Business, Innovation and Skills to provide relevant expertise in consumer and business experience.
  - Provision for reviews by an independent person of the economy, efficiency and effectiveness with which the FCA has used its resources in discharging its functions.
  - A new requirement on the FCA to make a report to HM Treasury in the event of a regulatory failure. Such a report would address the FCA's actions and decision making and consider what lessons can be learned by firms and regulators. HM Treasury must publish the report in full and lay it before Parliament unless there are good reasons not to. The emphasis is on regulatory failure; the FCA will not be responsible for all failures within firms. It is only where a significant failure is due to the FCA's actions, or failure to act, that a report will be required.
  - How this new requirement will operate in practice will require careful consideration. For example, the obligation to publish a report, and the desirability of transparency, should not impede or prejudice the FCA's ability to pursue enforcement investigations. In such circumstances, publication would be delayed until enforcement action is completed.
- 4.18 While the FCA will be accountable to government and Parliament, it is of course right that those subject to its regulatory decisions have access to an effective appeals mechanism. An important element in this process will be the scrutiny of an Independent Tribunal. The government is proposing to recognise here the important role that the regulator's judgement plays in certain types of regulatory decision (for example, in varying a firm's permission to carry on regulated activities). The FCA will ensure that its judgements are reasonable and proportionate.



CHAPTER | **FIVE**

# **Regulatory activities**

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- 5.1 The FCA will achieve its objectives through performing a number of inter-related functions. It will be an integrated regulator with an emphasis on cross-sector and cross-firm working. This will require teamwork and flexibility as staff move to tackle the areas of greatest risk. The FCA will need a balance between high-quality specialists and generalists in order to do its job effectively.

#### **Business and market analysis**

- 5.2 As set out in Chapter 1, the delivery of high-quality information-gathering and business analysis will be central to the success of the FCA. It will form the basis for the FCA's decisions on where to intervene and which tools to use.
- 5.3 Successful FCA interventions will necessarily depend on changing the way financial services markets work. Thus the FCA will need to operate a regulatory cycle of: diagnosis – remedy design – remedy implementation – review and further diagnosis. This in turn will depend on developing the tools, in particular economic tools, to assess markets at each stage of the cycle and on gathering the data needed for these tools to be used successfully.
- 5.4 Better diagnosis of problems and selection of the right package of remedies will require rigorous analysis of how consumers actually make decisions in the relevant markets and of how firms compete, including how those firms respond to consumers' behaviour. So, to improve its decision-making, the FCA will need to review both market behaviour and a market's structural features. It will build on the FSA's use of CBA to assess the likely effectiveness of different policy interventions by deploying fresh techniques.
- 5.5 Measuring whether markets are performing their role better following intervention is the real test of regulatory success and maximises accountability. The FCA will therefore consider developing further the ex-post CBA pursued by the FSA to identify the impacts of specific regulatory changes as well as using a set of strategic indicators to track changes in the efficiency and effectiveness of the various components of the financial system.

### **Risk framework**

- 5.6 The FCA will be a risk-based regulator and its risk framework will be the engine room of the business, providing support to the key activities, namely: supervision, policy, enforcement and authorisation. The FCA's risk framework will enable it to make a consistent comparison of the many varied issues it faces from which decisions on the prioritisation of resource allocation can take place. In its evaluation of issues, including the weakness of competition, it will be equally important for the FCA to consider positive opportunities to promote its outcomes as well as the risks that its outcomes will not be achieved.
- 5.7 Given its broad remit, the FCA will need to consider detriment when carrying out its risk assessments. In quantifying detriment, the FCA will assess probability and impact. Impact will be further broken down into incidence (for example, the number of consumers affected or potentially affected) and severity (for example, the amount of welfare or detriment involved per consumer). Such assessments will be based on current understanding of the risk or opportunity as well as reasonable expectations of how they will develop under a variety of scenarios. This type of analysis will help to support the FCA's aim of intervening earlier and more swiftly to prevent detriment, by evaluating the costs and benefits of the timing of any action.
- 5.8 The response by society as a whole and, in particular, in Parliament and the media to the major mis-selling events since 1990, demonstrates that the FCA will need to have a lower risk tolerance than the FSA has had historically in this area. This has implications for the intensity of the supervisory model and willingness to intervene.
- 5.9 The FSA is currently working on the details of the required risk model. In particular, the FSA is examining how to develop a unified methodology which covers different types of risk – retail conduct, wholesale conduct and prudential, and between firm risk and thematic risk. This will be covered in future publications.

### **Supervision of firms**

#### Overall approach

- 5.10 The FCA will build on, and develop further, the FSA's revised conduct strategy launched in 2010. The shift to a more proactive and outcomes-focused style of supervision has had four main elements:
- a more forward-looking assessment of potential detriment to identify, earlier, problems to be tackled;
  - delivering intensive supervision of firms, including earlier intervention in the development of retail products;
  - where failure does occur, securing the appropriate level of redress; and
  - achieving credible deterrence by taking action against firms that fail to meet standards.

- 5.11 The FCA will retain and enhance this forward-looking approach to protecting consumers. For example, research and risk analysis for an extended forward time horizon (18-24 months), as set out in the *Retail Conduct Risk Outlook* published in February 2011, will be complemented by other research and intelligence gathering (covering the operation of markets, industry trends, new products and the like) to identify potential and emerging conduct risks and poor consumer outcomes. The FCA's judgements will need to be based on this kind of scenario planning.

#### Supervisory design

- 5.12 The FCA's supervisory framework is currently being developed. The main elements are likely to include the following:
- **Forward-looking and preventative:** the FCA will design an approach that includes enhanced sector and cross-sector analysis, use of market and consumer intelligence, and regular engagement with external stakeholders who can provide early insights into potential conduct problems. Through this and through firm-specific and thematic work, the FCA will aim to identify the root causes of problems and intervene promptly to address these in the most effective way. The effective use of data will improve the FCA's supervisory approach and to that end it will look at measures to ensure the accuracy of the data it receives from authorised firms.
  - **Regulatory contact:** the FCA will aim to have direct regulatory contact with all firms through an approach that will be differentiated according to how the FCA categorises firms but with elements of consistency across them. Overall, the number of firms supervised on a 'relationship managed basis' will be significantly reduced; the FCA will build on the FSA's small firms supervisory approach and apply it across a wider range of firms. This approach will use regulatory returns, thematic work and generic (sector-focused) profiles. At the larger end of the firm spectrum, the FCA will build on recent work that focused on using business model analysis to identify drivers of conduct risk for firms and sectors. This, again, will be supplemented by a greater use of thematic work around regulatory priorities.
  - **Prudential supervision:** the FCA will be responsible for the prudential supervision of just under 24,500 firms. All firms will be subject to a minimum level of baseline supervision in line with international standards. For the vast majority, prudential supervision will be on a 'gone concern' basis. In other words the focus will be on ensuring that firms can fail in an orderly manner, with appropriate levels of consumer protection, through the FSCS, and the protection or segregation of client assets. As with conduct regulation, there is likely to be a small number of firms whose failure, even if orderly, could threaten the integrity of a particular market. Examples include large asset managers whose trading activity is disrupted and investment firms who deal as principal and are therefore the counterparty to consumers (both wholesale and retail), such as inter-dealer brokers. For these firms, the FCA will follow a more active supervisory programme on a 'going concern' basis. This should give the FCA sufficient time to intervene when problems occur and satisfy itself that the firm can be allowed to fail in an orderly fashion.

- The FCA will be the prudential and conduct regulator for a significant number of wholesale small and medium sized enterprises (SMEs), covering such activities as corporate finance advice, hedge fund asset management and other institutional wealth and long-only management boutiques. The FCA recognises that this community is an important part of the City of London and that the oversight of this group will need to be tailored to reflect its own particular set of issues.
- Firms' culture: the FCA will place particular focus on firms' culture as a potential root cause of poor outcomes for retail or wholesale consumers, recognising its determining role in a firm's regulatory behaviour. Consistent with the responsibility which firms and their senior management have for good consumer outcomes, the FCA will look to firms' governing bodies to set, embed and maintain a firm-wide culture that supports choice and an appropriate degree of protection for consumers. That culture will need to take into account factors such as the firm's business plan, risk appetite, remuneration mechanisms and identified internal and external risks. The FCA will expect boards to provide continuing oversight, particularly at times of significant change.
- Audit: the FCA will take forward the FSA's view that firms' auditors can and should play a role in supporting prudential and conduct supervision. The FCA will operate in accordance with the current code of practice for the relationship between the external auditor and the supervisor jointly produced by the Bank of England and the FSA. The FCA will continue to require firms which hold client assets to be subject to client asset audits.

### Lessons from the past

- 5.13 In designing its supervisory approach, the FCA will look not only at how future risks can be identified more effectively but also at the lessons which can be drawn from the past. A vital supervisory outcome will be to avoid such large-scale losses for consumers and disruption to both firms and the market from events such as the mis-selling of personal pensions and endowment insurance (see Box 4).

#### BOX 4: PAST MIS-SELLING

##### Pensions mis-selling

Between 1988 and 1994 millions of consumers were advised to take out personal pension plans when they were already members of, or had access to, an occupational defined benefit pension scheme. In addition, many employees who had preserved pensions with the scheme of a former employer were advised to transfer into a personal pension scheme. Much of this advice was unsuitable, generating commission for advisers but reducing benefits for transferees.

The seriousness of the problem was not identified for several years until a report by the Securities and Investments Board at the end of 1994. The exercise ultimately involved over £10 billion of redress to consumers, at great financial and reputational cost to the industry and regulators. It damaged consumer confidence and caused years of anxiety to millions of consumers.

**BOX 4: PAST MIS-SELLING (CONTINUED)****Mortgage endowment policies**

Mortgage endowment policies were widely sold to borrowers from the 1970s onwards and constituted the majority of new mortgage sales; by 2000 there were more than 12 million live policies. However, as inflation increased and returns fell during the 1990s, the presumptions that the products were safe and suitable for all were undermined.

Growing public criticism that sales advice had often been poor, with weak disclosure of the risk that investments might not cover the mortgage, and little consideration of suitability, was confirmed by the work of the Personal Investment Authority and subsequently the FSA. The market collapsed, with the residual problem of past mis-selling and the potential shortfalls of endowments against consumers' mortgage liabilities. Regulatory action led to a solution for dealing with individual complaints in which the ombudsman service played a critical part. These individual case solutions led to £3 billion of redress being paid to consumers and to enforcement actions with nearly £10 million of fines.

In retrospect, regulatory action was slow. Regulators were reluctant to acknowledge the scale of the problem and acted only after public concerns had been raised. Firm assessments were uncoordinated and inconsistent. Subsequently regulators were not sufficiently pro-active in ensuring that consumers who had been mis-sold policies received timely redress.

- 5.14 In both these cases, the regulators had to sort out major problems after the event. Both cases highlight the importance for the FCA of the early identification of potential problems in the market. Equally, they underline the need for early intervention as soon as problems have been identified to prevent consumer detriment and reduce the costs to the market of any widespread failure.
- 5.15 The FCA can also build on the FSA's recent experience with PPI. Although ultimately successful, here too there are lessons to be learned (Box 5).

**BOX 5: PAYMENT PROTECTION INSURANCE**

The FSA's actions taken in the PPI market illustrate the type of intervention that the FCA will make. PPI was a major retail market, with sales of over 5 million policies a year during 2000 to 2005, with premiums in the region of £7 billion a year. It was very profitable for firms. Often the underlying loan served as a loss leader on which to sell PPI. It was targeted at consumers taking on debt, many of whom were financially vulnerable, as their focus was typically on securing the loan with the insurance incidental to the transaction.

The FCA can build on and use some of the techniques which the FSA used to correct and prevent future problems. These included mystery shopping and examination of consumer outcomes which highlighted failures in firms' practices that were causing consumer detriment. Firms were asked to stop selling single premium policies, which they agreed to

**BOX 5: PAYMENT PROTECTION INSURANCE (CONTINUED)**

do, and the FSA introduced new rules backed by evidence of market failures and cost benefit analysis. It adopted a proportionate approach to redress for consumers, tailored to the range of PPI products available in the market and the range of identified failures. Tough enforcement action was taken against 24 firms. The FSA cooperated closely with the ombudsman service, the FSCS, the Office of Fair Trading (OFT) and the Competition Commission throughout.

The FSA was ready to defend its judgement in Court and did so. The strategy has led to the likely pay-out of billions of pounds in compensation to consumers who suffered mis-selling. The decision of the High Court supported the FSA's reliance on Principles, as well as rules and guidance, in setting the standards for firms' treatment of consumers.

- 5.16 The FSA recognises that, overall, its response to the mis-selling of PPI should have been stronger. Stronger action sooner could have limited the growth of the problem. The PPI market shows cultural challenges that the FCA will need to address if it is to prevent the crystallisation of large-scale risks and widespread consumer detriment. In particular, the FCA will need to: spot issues earlier; be willing to intervene early to improve standards either in specific firms or wider; take robust action designed to address weaknesses in competition revealed by economic analysis; give greater recognition, sooner, to the importance of securing redress (and not leave this solely to the ombudsman service); and, improve cooperation and working arrangements with the ombudsman service to ensure regulatory issues which complaints are revealing are dealt with sooner.

## Supervision of markets

- 5.17 The government has recognised that the FSA's approach to the regulation of markets for capital-raising and trading has worked well, in many respects. The government is proposing to extend the existing powers in some areas. The FCA's approach will therefore have significant continuity with the FSA's and will mainly be concerned with ensuring the integrity and efficiency of markets, ensuring adequate disclosure of information and providing a level playing field for market participants.
- 5.18 Market regulation has a wide scope, spanning the entire capital markets transaction chain. It encompasses investors, issuers, intermediaries from both 'buy' and 'sell' sides, and the various marketplaces themselves. The FCA's core markets regulatory activities will continue to be centred on: supervising the infrastructures which support trading of financial instruments; supervising the markets for the issuing of securities, including acting as the UK competent authority for listing; and maintaining a broad oversight of both on-exchange and OTC markets and detailed monitoring to prevent market abuse.
- 5.19 The FCA will focus its direct supervision of trading infrastructures on a relatively small number of entities which provide key services to the markets – particularly recognised investment exchanges and multilateral trading facilities. Due to the important role of these infrastructures and markets, the FCA is likely to pursue close and continuous institution-specific supervision as part of its regulatory model.

- 5.20 In the primary markets, the government has confirmed that the FCA will perform the functions that the FSA currently performs as the UK Listing Authority. The current regulatory approach, involving the maintenance of standards beyond European norms in certain areas but within the overall EU legislative framework, has demonstrated its value in balancing investor protection and the needs of issuers in raising capital. The FCA will therefore continue to be responsible for reviewing and approving prospectuses and circulars, determining eligibility for listing and maintaining the Official List.
- 5.21 The FCA will also police the ongoing compliance of issuers and major shareholders with the ad hoc and periodic disclosures required under the Disclosure and Transparency and Listing Rules. The FCA will authorise and monitor the performance of sponsors and, if proposed reforms are enacted, primary information providers. The major regulatory tool in this area will remain ensuring that disclosures made by issuers, both in key documents such as prospectuses, and on a continuing basis, provide the information required to protect investors.
- 5.22 The FCA will continue to build upon the success of the credible deterrence strategy agenda across the whole range of markets regulation. It will pursue this strategy vigorously in relation to conduct which puts integrity at risk, such as insider dealing and market manipulation. This will be supported by the government's decision to confer on the FCA the FSA's powers to bring criminal prosecutions as well as civil action.
- 5.23 Most elements of the regulatory regime for markets are now established at the EU level. The FCA will therefore need to prioritise engagement with Europe and particularly the European Securities and Markets Authority (ESMA), which will have a central role in drawing up detailed standards and monitoring the performance of market-facing supervision by national regulatory authorities (see Chapter 6). EU legislative changes in prospect are likely to extend the FCA's market-facing responsibilities.

#### Wholesale conduct

- 5.24 The FCA will put greater emphasis on wholesale conduct and the risks attached to activities in the wholesale markets. Wholesale conduct covers a broad range of activities, including the activities of participants on traded markets and their dealings with 'non retail' customers and the internal organisation of wholesale firms. As an integrated conduct regulator, the FCA will look across the whole financial services sector, not only in investment and capital markets but also in banking and wholesale insurance markets.
- 5.25 The FCA will recognise that wholesale conduct can have implications, including systemic consequences, beyond the confines of the transaction or market in which it takes place. Accordingly, the FCA will take a much greater regulatory interest in whether various wholesale markets have the potential to damage the interests of consumers and the wider economy.
- 5.26 In this context, the FCA will recognise that, although retail consumers are not generally direct participants in wholesale activities, wholesale activities can have a direct impact on retail markets and, ultimately, on those individuals who rely on

financial services and products to meet their needs. In practice, this will involve considering the interactions and linkages across the financial value chain where risks are transmitted between wholesale and retail consumers. In particular, intervention at the top of the value chain, targeted at product governance, must be considered to the extent that wholesale products filter down or are distributed to retail consumers.

- 5.27 Significantly, the FCA's regulatory interest in wholesale activities will range beyond the transmission of risks to retail markets. It will focus on whether certain behaviours in wholesale markets between wholesale participants can cause damage to the wider market and the economy at large. The design, marketing and mis-selling of high risk mortgage-related securities principally involving sophisticated wholesale participants is a well-documented factor in the recent financial crisis. The FCA will take a bolder, more intrusive approach in considering and scrutinising such practices.
- 5.28 The FCA will expect wholesale firms to be more open about their regulated activities and will harness the power of transparency to achieve greater market discipline. Participants in wholesale markets are better able than participants in retail markets to use such data.

#### Supervision of client assets

- 5.29 The financial crisis, including the collapse of Lehman Brothers, highlighted concerns about the safety of client assets, leading to the creation of a Client Asset Unit in the FSA, pooling specialist expertise across risk, policy and supervision disciplines. The aim was and is to enhance confidence in the UK regulatory regime's ability to deliver adequate protection of client assets, a critical component for a successful financial services industry. The Unit's drive for higher standards in safeguarding client assets embodies the FCA's ethos of pre-empting risk through a proactive, intrusive approach and a willingness to intervene early before detriment occurs. This approach illustrates that tackling a conduct issue in firms and in markets spans all sectors and types of consumer. Work in this area is already fully aligned with the FCA's strategic objective of protecting and enhancing confidence in the UK financial system.

#### Authorisation and approvals

- 5.30 The detailed procedures for authorisation and approving individuals for dual-regulated firms are set out in HM Treasury's June 2011 White Paper: *A new approach to financial regulation: the blueprint for reform*. For the firms for which the FCA is both the conduct and the prudential regulator, the fundamentals of the FSA's authorisation function will carry forward into the FCA. It will consider, in particular, the proposed business model, governance and culture as well as the systems and controls the firm intends to put in place, especially over product governance, the end-to-end sales processes and the prevention of financial crime.
- 5.31 As with firm authorisations, the FCA will work closely with the PRA in considering applications to approve individuals to 'Significant Influence Functions', namely roles which have a material impact on the conduct of a firm's regulated activities. The FCA will assess whether applicants understand the FCA's conduct of business requirements and take their personal responsibilities for meeting these standards seriously. The

FCA will seek to assess whether applicants have a good understanding of how to ensure good customer outcomes through corporate culture, appropriate conduct risk management and product design.

- 5.32 The FCA will also consider carefully how its approach at the gateway affects competition in the relevant markets. Its primary concern, however, will be the ability of firms to meet and continue to meet Threshold Conditions. Similarly, the FCA will approve individuals only if it is satisfied with their personal integrity and understanding of and commitment to the obligations which they are taking on.

#### Policy/Rule making

- 5.33 The FCA's conduct policy will be guided by the principles set out in Chapter 4 and will, as noted earlier, be substantially driven by requirements in EU legislation. In addition, it will:

- be supported by early and rigorous market analysis, business model analysis, and deep market failure analysis, informed by the new business and market analysis team;
- take full account of the new competition duty, for example, by considering options to promote competition where these may be relevant to resolving the market failures identified;
- be based on an understanding of commercial drivers, with a willingness to change such drivers where other interventions have not proved adequate to deliver appropriate consumer protection;
- develop in a way which is open, listening, consultative and sensitive to the impact it will have on the market;
- focus on clarity of expectations, both in terms of what consumers can expect and what the FCA expects of firms;
- rely on principles as well as rules and guidance to set standards for firms in conduct regulation;
- focus on the practicality of holding firms to these standards and principles – Handbook requirements should support clear-cut and effective supervision and enforcement action where necessary;
- maintain strong traditional disciplines under the principles of good regulation (e.g. of cost benefit analysis and respecting firms' and consumers' responsibilities); and
- follow up new policy with rigorous post-implementation reviews to evaluate the success of FCA's policy interventions, their impact and the residual risk.

- 5.34 As a conduct regulator, the FCA will oversee a number of different ownership structures, including mutuals, building societies, credit unions and friendly societies. It will recognise the importance of tailoring its approach, given the specific nature of the organisations it regulates, including recognising different characteristics of different ownership structures. It is not the FCA's role to promote particular ownership structures; but it does have an objective to promote efficiency and choice, and recognises that diversity of business models can contribute to that objective.

## Financial crime

- 5.35 The FCA will focus its resources on firms which are particularly exposed to financial crime risk. It will give higher priority to the protection of consumers as potential victims of financial crime, and to the use of firms as a conduit for financial crime, than to the protection of firms themselves as potential victims.
- 5.36 In line with the FCA's emphasis on pre-emptive problem solving, it will concentrate on identifying current and emerging financial crime threats, and on ensuring that an awareness of their implications and how to mitigate them is embedded across its operations. By doing so, the FCA can ensure that firms maintain, and where necessary enhance, their systems and controls against financial crime.
- 5.37 The FCA will build on the FSA's intensive and intrusive supervisory approach and its emphasis on credible deterrence in supervising how regulated business manages financial crime risk. To achieve this, it will continue to use techniques such as thematic reviews involving detailed testing to determine whether firms are meeting their legal and regulatory obligations. It will also strengthen the feedback between risk identification, analysis and dissemination of its findings from any one sector to drive up standards across the whole regulated community.
- 5.38 The FCA will be able to impose penalties for market abuse, as the FSA currently can under Part 8 of FSMA. It will have the power to undertake criminal prosecutions for insider dealing and market manipulation (other than in Scotland).
- 5.39 The FCA will work closely with other agencies involved in the fight against financial crime. These include the Serious Organised Crime Agency, the Serious Fraud Office, the City of London Police and the proposed National Crime Agency as well as the relevant bodies in other countries.

**Redress**

- 5.40 As set out above, the FCA will build on the existing successful strategy to deliver credible deterrence and require firms to provide prompt and effective redress. The FCA will strengthen its use of existing supervisory powers to ensure that firms are not benefiting from exploitation of market failures. It will ensure that past business reviews will be rigorous and will be diligent in setting the requirements for these reviews and their execution.
- 5.41 The FCA will have additional tools to facilitate consumer redress. It is the government's intention that the new FSA power to establish consumer redress schemes will be given to the FCA. The FCA will be willing to establish such schemes, working with the ombudsman service and other stakeholders, in order to put right consumer detriment where there have been widespread or regular failings in firms' conduct. These schemes should prove a powerful tool which the FCA can use to secure good outcomes for a large number of consumers.

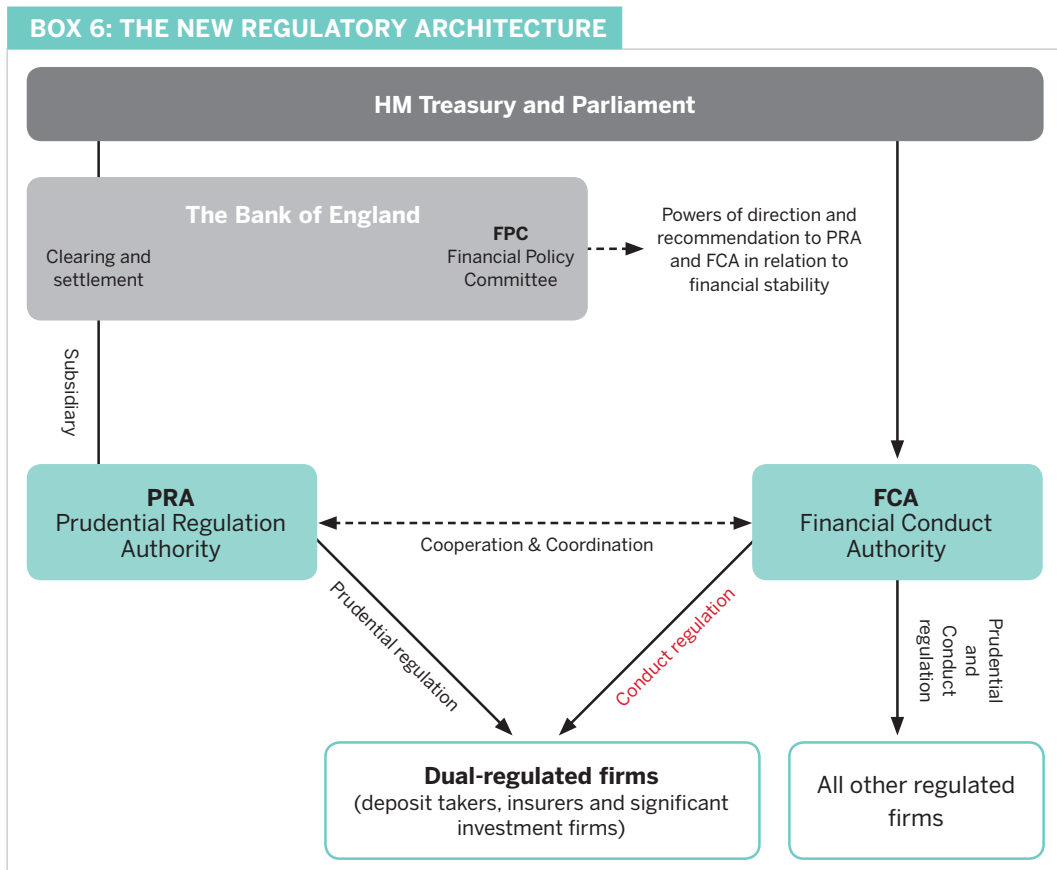
5.42 The government has also put forward a proposal that, if and when there may be a need for large-scale consumer redress, there is a clear process in place to ensure that the issue is tackled by the FCA thoroughly and promptly. As indicated in HM Treasury's June 2011 White Paper: *A new approach to financial regulation: the blueprint for reform*, this would provide for a range of organisations, including the ombudsman service and consumer groups, to make a referral where they think that there may be mass consumer detriment. The FCA would be required to respond within a certain time period and, where appropriate, set out the action it intends to take. The government has invited responses to this proposal and, if appropriate, will bring forward legislative provisions when the Bill is introduced.



CHAPTER | **SIX**

# **Coordination**

- 6.1 Box 6 below sets out the regulatory architecture proposed by the government. Effective coordination will be central to the success of the new arrangements and will be achieved through a combination of formal and less formal mechanisms. Collaborative day-to-day working relationships will be essential.



## FCA coordination with other authorities in the UK

The FPC and the PRA

- 6.2 The areas in which the FCA will coordinate with the FPC are covered in Chapter 3.
- 6.3 The government proposes to impose a legal duty on the FCA to coordinate the exercise of its functions with the PRA, so that regulatory processes will operate efficiently and effectively. This duty will be supported by a statutory requirement for the FCA and the PRA to agree and publish a Memorandum of Understanding (MoU) setting out how they will deliver that duty. The government also proposes to legislate for cross-membership of boards; the Chief Executive of the FCA will sit on the board of the PRA, and vice-versa, to support coordination at a strategic level. Information gateways will be set up to allow the free flow of information between the two regulators where needed.
- 6.4 At an operational level, to ensure that the statutory duty to coordinate is effective in practice, the FCA and the PRA will put in place arrangements for coordinating their operation of regulatory processes which affect dual-regulated firms and, where appropriate, for the consolidated supervision of groups. These arrangements will include:
- Supervisory colleges, through which regulators can share their views of the risks posed by a firm or group and discuss mitigating actions. This reflects the need to avoid conflicting directions to firms by the two regulators.
  - Working closely with the PRA throughout the authorisation process, assessing a firm's business model, its governance and product range relevant to the FCA's objectives.
  - Provision for the FCA to notify the PRA before taking enforcement action.
  - The two regulators will consider how best to put in place common standards and rules for risks which are directly relevant to both authorities' responsibilities, for example, governance and systems and controls.
  - Coordination in setting policy and rules, including ensuring that policy on the prudential and conduct sides are complementary.
  - Coordination will need to be particularly close in respect of with-profits insurance business. The government has recognised that this is a complex area and is considering further whether explicit legislative provision may be necessary to ensure that coordination will be efficient and effective.
  - A requirement that the PRA and the FCA must include an account of how they have coordinated and cooperated in their annual reports.

The Bank of England

- 6.5 The government is proposing that the Bank of England will be responsible for regulating central counterparty recognised clearing houses and settlement systems. The FCA and the Bank will ensure effective co-operation and information sharing in respect of regulation of market infrastructures supporting trading, clearing and settlement where this is necessary to support the objectives of both organisations.

The Financial Ombudsman Service, the Financial Services Compensation Scheme and the Money Advice Service

- 6.6 The FCA will set out the regulatory framework to provide protection from detriment for retail consumers. As noted earlier, it will also liaise closely with the three other organisations which have an important role in the consumer protection framework (Box 7).

#### BOX 7: THE OMBUDSMAN SERVICE, THE FSCS AND THE MONEY ADVICE SERVICE

An important protection for consumers who are dissatisfied with the service or product they have bought is their right (under FSMA and the regulator's rules) to complain to the firm responsible, to have their complaint assessed fairly, and to receive redress where appropriate. If consumers remain dissatisfied with the response of the firm to their complaint, they will continue to have the right to refer their case to the **ombudsman service**. The ombudsman service provides, free of charge to the consumer, an independent service to handle complaints by consumers against firms and, if necessary, forms an independent assessment of the complaint and a decision on it.

Where a consumer has suffered detriment from poor conduct by a firm which has failed financially or ceased to trade and so cannot pay the redress required, the **FSCS** will pay the redress due (drawing on funds levied from other firms doing similar kinds of business), within specified limits. More generally, where a firm has failed financially and cannot honour its liabilities, the FSCS will, again within specified limits, pay those liabilities (such as bank deposits, insurance claims or client money that was invested).

The FCA may also wish to draw on the FSCS' experience in bringing out the lessons from past failures. The FCA and the FSCS could work together on firm-specific as well as general contingency planning for potential problems in the future. The FCA will review FSCS rules on a continuing basis to ensure that they continue to serve its statutory objectives.

The role of the **Money Advice Service** is covered in Chapter 3. It was set up in 2010 and launched in April 2011. Its purpose is to give free, unbiased money advice online, over the phone and face-to-face to help people manage their money better.

Coordination and information sharing between the FCA and these three organisations will be an important element for the success of the new regulatory arrangements.

- 6.7 The government intends the ombudsman service to remain an operationally independent dispute resolution service and for the FCA to take on the FSA's existing functions in relation to the ombudsman service. The government will legislate to require the FCA and the ombudsman service to publish and maintain a statutory MoU, which will set out how they will work together. The government will require the ombudsman service to pass to the FCA any information which the ombudsman service considers could assist the FCA to advance its objectives and the FCA will be required to have regard to this information in fulfilling its objectives. The government will clarify the ability of the ombudsman service to publish information.

- 6.8 These mechanisms should enable the FCA to make full use of the information held by the ombudsman service on firms' treatment of their customers and handling of their complaints. If the FCA is successful in dealing with the major causes of consumer detriment before their effects become widespread, using its enhanced powers to act early and decisively, this should help to ensure that the ombudsman service is able to focus on its core function of dealing with individual disputes on a case-by-case basis.
- 6.9 In the new framework both the FCA and the PRA will have rule-making powers for the FSCS – the PRA for compensation and fees rules on deposits and insurance provision, and the FCA for all other types of financial activity covered by the FSCS. The two regulators will be jointly responsible for oversight and associated functions (for example, board appointments) in relation to the FSCS. The government intends to legislate to require the FSCS to put in place an MoU with the FCA to strengthen transparency and accountability.
- 6.10 The FCA will have the same responsibilities in relation to the Money Advice Service as the FSA currently has. The government intends to require the FCA to agree and publish a MoU with the Money Advice Service, replacing the current voluntary arrangement. The Service will be a further useful source of intelligence and early warnings for the FCA on potential problems in retail markets.

#### **Coordination with EU and global stakeholders**

- 6.11 The FCA's policies and activities will be set in an international context. The open nature of the international financial system and, in particular, the single internal market in the EU, means that a high degree of coordination is necessary between national regulatory authorities to reduce the risks to market confidence and consumer protection. With the other UK authorities, the FCA will play an active and constructive role in shaping the development of the common framework for regulation and supervision at a global level and in the EU. The government plans to legislate to require the establishment of an MoU between the Treasury, the Bank of England, the PRA and the FCA on overall international coordination within the UK's system for financial regulation.
- 6.12 In particular, the FCA will represent the UK in ESMA, and will similarly have lead responsibilities for securities and markets issues at the global committee level. The FSA already has a seat on ESMA's Management Board and chairs the Secondary Markets Standing Committee. It will be fully involved in the development of draft binding technical standards (detailed rules which apply directly to relevant institutions across the EU). The FCA will continue this work and take forward the FSA's approach in playing a full part in the delivery of the internationally agreed post-crisis agenda for strengthening the soundness and integrity of markets.
- 6.13 The FCA will work closely with the Financial Reporting Council and the Bank of England as well as the PRA to ensure that their interests are also represented in ESMA discussions. It will support the PRA in representing UK interests in the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA). This will be particularly important as conduct issues will come within the scope of both EIOPA and the EBA.

- 6.14 The current EU agenda has a strong consumer protection focus, including issues under the Markets in Financial Instruments Directive and the review of the Insurance Mediation Directive. The FCA's priorities in these areas are likely to have much in common with EU consumer protection goals; at the same time, the FCA will also want to tailor regulation in a way that addresses specific market failures in the UK. At present, there are fewer cross-border activities in retail compared with wholesale markets.
- 6.15 There is a move towards establishing harmonised prudential standards in Europe and the new European Supervisory Authorities have the power to set binding technical standards. It will be important for the FCA that the EU policy framework leaves scope for it to make informed judgements about the risks to its objectives and the actions it wishes to take.



CHAPTER | **SEVEN**

# **Next steps**

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- 7.1 The government currently envisages that the new regulatory architecture will be in place by the end of 2012. In the interim, the FSA will continue its work on the detailed design of the FCA, taking full account of the legislative process as well as the views of stakeholders. The FSA will publish further proposals on the FCA's operating model in the coming period.

#### COMMENTS AND FEEDBACK

The FSA would welcome comments, and would ask that you send them to [FCAApproach@fsa.gov.uk](mailto:FCAApproach@fsa.gov.uk) by 1 September 2011. Further information and proposals on the FCA's approach will be published over the coming period.





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