

Better Regulation Action Plan

What we have done and what we are doing





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December 2005

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Foreword



I am pleased to introduce this paper setting out how we plan to continue improving the regulation of the financial services industry. Regulation exists because of the potential economic and social effects of major financial instability, the desirability of maintaining markets which are efficient, orderly and fair and the need to protect retail consumers in their dealings with the financial services industry. We do not hear arguments against the existence of regulation in these contexts. But we do hear extensive debate about how regulation is conducted.

Currently, our approach to regulation is a hybrid of high-level principles and detailed rules and guidance. While this broad structure is both necessary and desirable, we aim where we can to change the balance significantly towards a more principles-based approach. We believe this can produce better outcomes for both consumers and the financial services industry by encouraging a focus on how best to act in a particular situation, rather than simply following a mechanistic process. The shift towards a more principles-based approach will take

time to implement, as much care will be needed to ensure that we retain rules which clearly add value in maintaining efficient, orderly and fair markets or helping consumers secure a fair deal.

There are also significant practical and legal constraints on how far we can go towards a more principles-based approach, such as the need to meet EU obligations. We reaffirm our commitment to implementing directives in a sensible and proportionate way. We must implement the minimum requirements, even if they would fail a cost-benefit analysis from the viewpoint of the UK. But we will not gold-plate EU requirements. We will only add additional requirements when these are justified in their own right.

We will continue to work with the industry where possible, so that they own solutions to market failure problems. As this paper sets out, we have successfully promoted market solutions in a number of areas already. We will also continue to act as a catalyst for raising standards and clearing-up past problems in respect of both domestic and international issues,

as we have in the credit derivatives market. We are mindful of the need to have particular regard to the potentially anti-competitive implications of raising standards to a level above those needed to achieve the FSA's objectives.

This paper summarises what we have done already to improve the way we regulate and what we are doing currently to improve further. Much of our work is about making us easier to do business with and improving the communication of our requirements in a way which will help businesses of all shapes and sizes understand the implications for them. Separately, we are conducting a major project together with the Financial Services Practitioner Panel, to understand better the costs of regulation and to identify areas where the costs may exceed benefits. We will report on this work during the first half of next year.

A handwritten signature in dark ink, appearing to read 'John Tiner' with a stylized flourish at the end.

John Tiner

Introduction

Purpose

This document outlines how we have improved – and will continue to improve – the regulation of the financial services industry. This means regulating less where we believe we can, but more where we think it is necessary. Our work to improve regulation reflects a recognition that there may well be areas where it needs improvement. Despite our desire to remove unnecessary regulations, there are areas where regulation may increase, and we recognise the drivers of this.

We are always open to further concrete suggestions about areas of regulation which stakeholders believe could benefit from review and where there is scope for change. Please continue to send comments to: betterregulation@fsa.gov.uk.

Feedback

In July this year we asked for suggestions of areas of our Handbook of rules and guidance that should be reviewed. Four clear messages came through in the responses. First, there is concern at the volume of regulatory change resulting from our having to implement European directives. This led to calls for us to be selective about making discretionary changes. Respondents asked that we use the implementation of European directives as an opportunity to

undertake a fuller review of the affected parts of the Handbook. Second, in their responses many newly-regulated mortgage and general insurance firms encouraged us to keep the rules applying to those sectors as they are. Some suggested specific areas for review, which will be fed into the review of those regimes. Third, many respondents wanted us to pursue our work on making it easier to access and understand our regulatory requirements. Fourth, there was support for a more principles-based approach, although firms highlighted how valuable they find guidance in some areas and said they would not want to lose this.

Against that background, this document sets out what we are doing to improve regulation across the full range of our activities, as we said we would in Consultation Paper 05/10 *Reviewing the FSA Handbook*¹.

Context

Our approach to improving regulation has to be seen in the context of our responsibilities and powers. We regulate around 27,000 firms covering a vast range of sizes and activities, from international investment banks operating in wholesale markets to small retail firms selling mortgages on the High Street. Over 90% of these firms are classified by us as small.

How we regulate these firms is ultimately governed by the Financial Services and Markets Act 2000 (FSMA), which gives us four statutory objectives and several principles of good regulation to guide how we operate. These principles include the need for proportionality when imposing restrictions, facilitating innovation and competition, and maintaining the competitive position of the UK. A report prepared for the Office of Fair Trading in December 2004 concluded that FSMA is likely to have had a positive effect on competition in the financial services industry. Further details of our responsibilities and approach can be found on our website: www.fsa.gov.uk.

Regulation exists because of the potential economic and social effects of major financial instability, the desirability of maintaining markets which are efficient, orderly and fair and the need to protect retail consumers in their dealings with the financial services industry. We do not hear arguments against the existence of regulation in these contexts. But we do hear extensive debate about how regulation is conducted. We are committed to promoting better regulation by ensuring that the overall benefits of our regulation outweigh the costs, and that we maximise those benefits. We do this in the following ways.

- We tackle our objectives in a risk-based way. This accepts some risk

¹ http://www.fsa.gov.uk/Pages/Library/Policy/CP/2005/05_10.shtml

of failure but helps deliver a proportionate response.

- Where we have discretion, we intervene in markets only when there is a market failure and where regulatory intervention is likely to be cost-effective. Two independent reports we commissioned highlighted the substantial benefits of our cost-benefit work and the international reputation we have earned in this area². We recognise that we must build on the progress we have made and continue to take on board new insights from external experts, for example to help develop our use of cost-benefit analysis to review existing policies.
- Public consultation is central to the way we operate. It helps ensure we have heard all the arguments and understood the costs and benefits involved.
- We aim to change significantly the balance of our regulatory approach towards high-level principles.
- It is also our aim to keep the information we require from firms to the minimum.
- We look to remove old regulations when new ones are introduced. For instance, when implementing directives we take the opportunity to remove unnecessary or duplicative

existing material, and simplify the rules to make them easier to use. Our basic approach is to 'copy out' the text in our Handbook, adding interpretive guidance where that will be helpful. This avoids placing unintended additional obligations on firms. We will not gold-plate EU requirements. We will only add additional requirements when these are justified in their own right.

There are, though, constraints on the way we pursue better regulation.

- We are limited in the discretion we can exercise as we are obliged to implement European directives. The European Commission has indicated that it does not envisage a new legislative programme on the scale of that seen during 2000-05. However, there are several sectors that are being examined in EU fora with a view to possible further initiatives. This could amount to a significant future agenda, with implications for UK regulation. In this context, the European Commission's forthcoming White Paper on Financial Services 2005-10 might well address better regulation issues at the European level, leading to potentially beneficial effects in future, and we note the European Parliament's current

work on better law-making and impact assessment. In the coming years, we also expect to implement a number of measures currently in different stages of preparation. Further details are in our *International Regulatory Outlook*, published in November 2005³. Influencing and understanding the implications of the European agenda involve a considerable commitment of our resources, including senior management time.

- Our regulatory scope is established by the Government and is due to be widened to include Self-invested Personal Pensions, Home Reversions and Islamic home finance products. In addition, the Treasury is reviewing how a number of sectors are currently regulated, and what shape the new regulatory regime should take to meet the requirements of EU legislation. The sectors in question are: money service businesses; trust and company service providers; payment service providers; and firms providing consumer credit. Changes in the scope of our regulation set the challenge of establishing a regulatory model that suits the number and variety of firms and activities for which we are made responsible, whilst providing appropriate protections for consumers.

² http://www.fsa.gov.uk/pubs/other/nera_cba_report.pdf and http://www.fsa.gov.uk/pubs/other/howell_report.pdf

³ <http://www.fsa.gov.uk/pages/Library/corporate/iro/nov2005.shtml>

Improving regulation in practice

Since we assumed our full powers in 2001 we have sought to improve the regulation of financial services by reviewing and amending our requirements to make them more proportionate where we can, by making our regulation easier to understand and by making us easier to do business with. We will continue to look for ways to improve our regulation.

This section highlights some of the changes we have made in recent years and what we aim to deliver in the next few years that will most directly contribute to these objectives. More details on work in previous years can be found in our Annual Reports. Our Business Plan for 2006/07, which will be published on 1 February 2006, will include additional information and milestones on some of the initiatives outlined below.

Promoting efficient, orderly and fair markets

*More competition for
company announcements*

In 2002 we opened up to competition the system that listed companies use to make regulatory announcements, such as information on performance, financial position and transactions. Listed companies can now choose between six Regulatory Information Services to make their regulatory information available to the market.

*Simpler, more up-to-date,
listing rules*

Between 2002 and 2005 we undertook a fundamental review of the rules relating to listed companies, which simplified and modernised the regime. The regulatory burden was cut back for debt, secondary listing and depositary receipts and, after consulting the industry at length, we retained a higher level of protection for investors in primary listed securities. We removed the requirement for directors of an issuer to take responsibility for prospectuses relating to low denomination non-equity securities, which had been seen as a significant barrier to the creation of a retail debt market. The review simplified and re-structured the rules, reflected in a 40% reduction in their length. We also added six listing principles, which reflects our principles-based approach. We will also be consulting in 2006 on proposals to replace the Listing Rules that apply to investment entities with a simpler and more modern regime.

*Looking to make
shareholder notifications
more proportionate*

We are due to be given responsibility for the rules under which shareholders have to notify a company if they acquire or dispose of a major stake in it. We will be consulting in 2006 on whether to retain the current disclosure thresholds or move to the minimum requirements of the Transparency Directive, which would require fewer notifications and allow more time for those notifications to be made.

*Industry solutions for soft
commission and bundled
brokerage...*

In response to the challenge from us, the industry proposed in March 2005 a credible solution to the conflicts of interest arising from soft commission and bundled brokerage arrangements.

...dealing ahead...

In 2004 a group of four trade associations published industry guidance on their understanding of our rules relating to dealing ahead of investment research. We worked with the group to agree publicly that the guidance was consistent with the intended effect of our rules.

...and contract certainty

In 2004 we called on participants in the London insurance market to work together to develop within two years a market-driven solution to achieving greater contract certainty, ensuring clarity about the insured risk at the time the contract starts. We will only consider regulatory intervention if this does not correct the market failure we have identified.

Taking a measured response to the risks hedge funds present

During 2005 we have discussed with the hedge fund industry the risks funds can pose to our objectives and how we can mitigate those risks in a proportionate way. We will be publishing our feedback in 2006. In June 2005 we also started a dialogue with firms and consumers about the regulatory regime that applies to sophisticated investment products (including, but not limited to, hedge funds) and whether there is scope to allow retail access to a wider range of investment strategies. We will also be publishing our feedback in 2006.

Helping retail consumers achieve a fair deal

Removing barriers in retail advice

On 1 December 2004 we completed a reform of the market for retail financial advice to remove rules which required sellers of retail financial products to choose to do so either as product providers or as independent financial advisers. This removed barriers that may impede competition and innovation. It will also make it easier for consumers to shop around for advice and to exert a competitive influence on charges. We are now intending to review the effect of these changes on firms and consumers, starting next year.

Looking to reduce the costs of personal pension sales

We are currently considering responses to our consultation on removing the requirement for an adviser recommending a personal pension to explain to the customer in writing why that pension is at least as suitable as a stakeholder pension. This would introduce greater flexibility in the way personal pensions are sold, given the greater price transparency introduced under the new depolarised system.

Easier marketing of workplace pensions

In 2005 we removed rules relating to the marketing of stakeholder pensions in the workplace after we concluded that the potential market failure they were intended to guard against had not materialised. In July 2005 HM Treasury amended the Financial Promotion Order so that most employers can promote their stakeholder or group personal pensions to their employees without fear of infringing FSMA. We have amended our guide for employers on this subject.

More flexible rules for Collective Investment Schemes

We reviewed the rulebook for Collective Investment Schemes to produce a more flexible regime, introduced from April 2004. Retail investors have access to a wider range of investment opportunities and product features, and schemes available only to professional investors benefited from a reduction in regulation. Modernising and simplifying the rulebook also halved its length.

More freedom for Credit unions

In November 2005 we amended our rules to help further development and innovation in the credit union movement, without significant additional risks. We have also provided additional guidance on legislation that credit unions were interpreting in an unnecessarily restrictive way.

Simpler rules for conduct of business...

In 2006 we will be consulting on simplifying our rules relating to dealing with retail customers. This will include removing rules that are no longer effective or proportionate or which overlap, and we will review the balance between high-level and prescriptive rules. We will also revisit the provisions which implemented the Distance Marketing Directive and the Electronic Commerce Directive. We are using the substantial overhaul required to implement the Markets in Financial Instruments Directive (MiFID) as an opportunity to undertake this work.

...and for financial promotions

Also using the opportunity presented by implementing MiFID, we will consult in 2006 on overhauling and simplifying the requirements relating to firms issuing financial promotions, placing much greater reliance on the principle that financial promotions should be clear, fair and not misleading.

Reviewing the effectiveness of our mortgage and general insurance regimes

We will investigate the effectiveness of the new mortgage and general insurance regimes, focusing initially on how far our rules are delivering the intended outcomes for consumers. We aim to feed back the initial findings of the mortgage review in summer 2006 and those from the general insurance review towards the end of 2006. As part of these reviews we will consider opportunities to improve our regulation of these sectors. If after the first stage of the reviews we think any rule changes are necessary, we will consult on proposals in the usual way.

A voluntary code for banks

A voluntary code applies to the way retail banks deal with their customers (the Banking Code). In the light of this, we have not used our powers to start regulating the conduct of deposit-taking business, except to a limited extent to implement European directives.

Making professional firms exempt from our rules

Exempt professional firms do not require authorisation from us. Instead, they are able to carry on certain regulated activities as incidental to their professional services if they are subject to the rules and requirements of a designated professional body (such as the Law Societies and the Institutes of Chartered Accountants). We recognise nine professional bodies covering approximately 17,000 exempt professional firms. Approximately 740 professional firms do require authorisation but are only carrying out regulated activities in conjunction with their professional services. For those meeting certain criteria we operate a 'light touch' regime that means parts of our Handbook does not apply.

Working with industry on treating customers fairly

We will continue to work with the industry to develop a common understanding of our requirement to treat customers fairly. Through statements of good (and less good) practice and case studies we have illustrated some of the considerations that firms' senior management should take into account. This work has been undertaken with a consultative group drawn from trade associations and consumer bodies.

Improving our business capability and effectiveness

Looking closely at the costs we impose

In conjunction with the Financial Services Practitioner Panel we are undertaking a joint study to collect evidence in three specific financial services markets on the costs to firms of our regulation, the results of which will be published in 2006. We are also analysing the administrative burdens that we place on firms. We will consult on any resulting proposals to remove parts of our Handbook and consider other ways to reduce firms' costs.

Reducing bureaucracy for approved persons

We have consulted on proposals to reduce the burden of regulation of ‘approved persons’ in the wholesale financial markets, removing some of the detail in our rules and reducing form-filling and reporting requirements placed on employers of approved persons. We are currently reviewing the responses and will publish our conclusions early in 2006.

Emphasising senior management responsibility for money laundering controls

We have consulted on a proposal to delete our detailed rules on money laundering and replace them with a high-level requirement focussing on senior management responsibility. This approach reflects the existence of industry guidance developed by the Joint Money Laundering Steering Group. We are reviewing the responses and will publish our conclusions early in 2006.

Less detailed prescription for training and competence

Since July 2004 we have not prescribed in our Handbook the specific examinations that individuals conducting particular activities must pass. We have moved to a system which allows firms to choose an examination which is appropriate to their circumstances. A list of examinations maintained by the Financial Services Skills Council helps them to do this.

We have consulted on a proposal to delete detailed rules on training and competence for individuals dealing with non-private customers. The changes we are proposing are designed to reflect the risks for these customers and the potential for the Financial Services Skills Council to work with the wholesale industry to establish standards, with even less involvement from us. We are currently reviewing the responses and will publish our conclusions early in 2006. We are planning to undertake a wider review of all our training and competence requirements in 2006/07.

Reviewing our manuals

In 2006 we plan to complete work on dismantling our Authorisation manual, moving and deleting information to ensure that the remaining information is located in the most useful place for applicants and other users. We will also undertake a systematic review of all those aspects of our Supervision manual that impose an administrative burden on firms. We are considering whether to undertake a complete review of the Enforcement and Decision Making manuals to simplify them.

Lifting audit requirements on small firms

We agreed with the Department of Trade & Industry (DTI) in 2005 that small and medium-sized firms that sell mortgages and general insurance should be exempt from having their annual accounts independently audited. We estimate that up to 9000 firms are affected and that they would have paid audit fees of £1000 to £2000 each. We are now considering consulting on withdrawing the audit requirement for certain other types of low risk firm, contingent on a DTI decision to amend relevant provisions of the secondary legislation under the Companies Act, and also subject to European and primary legislation. This could affect up to 3,000 firms who may pay up to £1000 each in audit fees.

Improving our risk model...

Our risk-based approach to supervision (called ‘Arrow’) is widely recognised as one of the most advanced of any regulator in the world. Under this approach, the intensity of our work and the resource allocated to supervising individual firms reflect the size and risk of each firm. For instance, we no longer undertake regular monitoring visits to every firm, but target the highest risk firms and thematic issues. We have invested heavily in the last two years in updating and improving our approach to risk assessment and will continue to do so. We have recently delivered a new risk model for firms and for thematic risk assessments and are training staff on these changes.

*...and how we conduct our
'thematic work'*

Thematic work involves us looking at regulatory issues across a sample of firms from the relevant industry sector. It is an important component of our risk-based approach as it is not cost-effective to visit all firms routinely. We try to spread this work fairly among individual firms, but this can be a particular challenge when it comes to the largest groups. So, we are committed to holding regular discussions with the industry on this, setting out an indicative timetable for our future thematic work. We are also examining whether the process for communicating the outcome of thematic work to individual firms and to trade associations can be improved.

*Better guidance, greater
accessibility*

Improving the accessibility of our rules and guidance is very important to us. In June 2005 we launched 14 sector-specific tailored handbooks for small firms which provide the information from our full Handbook most relevant for each industry segment. These developments to our Handbook website received very positive encouragement from industry practitioners.

We provide extensive guidance on our rules and supporting material through our Handbook, on our website and in response to individual requests. We plan to build on the Tailored Handbooks by developing a 'build your own' Handbook facility to enable firms to draw together precisely those sections of the Handbook relevant to their own businesses. We are looking at developing a series of 'Key Rules' publications to help smaller firms understand the requirements that apply in their day-to-day activities.

Setting high service standards

We have set ourselves a range of measurable service standards for judging our interaction with firms and we publish details of our performance against these standards every six months. In October 2005 our results showed that for the 62 processes measured over the previous six months we entirely met 76% of our targets, achieved over 90% compliance for a further 19% of our targets, and failed to meet 5% of targets. We have demonstrated improvement despite significant increases in volumes since taking on mortgage and general insurance regulation.

We will publish by the end of March 2006 a 'statement of mutual expectations' of the supervisory relationship, setting out what firms can expect from us and what we expect from firms. It will set out the differences between those firms which have a dedicated relationship manager at the FSA and those that do not. We will then review our service standards and operating practices to ensure that we are meeting these expectations.

*Measuring our quality of
service*

We are committed to improving the service we provide and are measuring the quality of our service to ensure we focus on the issues of most concern to firms and to help us be proportionate. From April 2005 an independent research company has been conducting a tracking survey of firms' satisfaction with eight regulatory processes – generating a Customer Satisfaction Index for each (e.g. applications for authorisation and rule waivers). From February 2006 we will publish the results alongside our targets and benchmarks for each process.

*Making application packs
shorter*

We have introduced simplified authorisation packs for small firms in several sectors, reducing the average authorisation period for these firms by 25%. We have also made it easier for small and medium-sized authorised firms to change their legal status. We will extend this work to review the full application pack in 2006, aiming to make the forms clearer and reduce both the amount of information we request and the time it takes firms to supply it.

Making life easier for small firms

Small firms make up over 90% of the firms we regulate and we have developed a number of tools to make it easier for them to do business with us. These include a Firm Contact Centre to answer questions; a specific section of our website with up-to-date advice and information; regional ‘roadshows’ and surgeries. We have also refined the way we supervise small firms to make better use of information we hold, leading to better targeted supervisory action.

Improving our fees process

We are developing a Fees Calculator so all firms can calculate their likely fees and levies. There is now a single consultation process and invoice covering all regulatory fees and levies for us, the Financial Ombudsman Service and the Financial Services Compensation Scheme. We have also developed with the industry a facility for firms to pay fees by instalments. Over 3000 firms have now used this facility. We are currently consolidating all fee and levy rules into a single location from eleven parts of our Handbook.

Easier, more focussed, regulatory reporting

We have introduced an online facility so firms can check that the information we hold on them is correct; send us information and applications; and submit their regulatory returns. We have reduced the size and complexity of the returns insurance companies and some friendly societies must submit. The extent of reduction varies depending on the type of insurance business undertaken. Some firms reporting on their life business will have seen the amount of data required reduced by up to 60%.

We will continue to review our reporting requirements to ensure they reflect a risk-based approach, where possible reducing the information we ask for. We will be focusing in particular on implementing the Capital Requirements Directive (CRD) and MiFID reporting requirements, which will affect a large number of firms. Some types of firm may see their reporting obligations fall: banks and building societies could see the number of data fields they submit cut in half. Other firms may see an increase in their reporting requirements as we ensure that we collect the information necessary to support our statutory objectives. For all firms we will be aligning reporting deadlines with their accounting timetables, enabling them to use for regulatory purposes the information they generate for their own business purposes.

We will be reviewing three new forms – known as the Mortgage and Lending Activities Return (MLAR), Retail Mediation Activities Return (RMAR) and Complaints Return – in the third quarter of 2006 to assess whether we can remove any data fields.

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