



Principles-based regulation

Focusing on the
outcomes that matter

Contents

Ten point summary	2
1 Our regulatory approach	3
1.1 Introduction	3
1.2 The move to more principles-based regulation	4
2 Principles-based regulation	6
2.1 Why principles-based regulation?	6
2.2 What is principles-based regulation?	6
2.3 What are the benefits of principles-based regulation?	7
3 Impact of principles-based regulation	8
3.1 Changing the Handbook	8
3.2 Changing how firms experience FSA regulation	12
3.3 Measuring regulatory outcomes	14
4 Implications and challenges arising from principles-based regulation	17
4.1 Implications for firms	17
4.2 Challenges for the FSA	18
5 Key outstanding challenges and constraints	20
Annex: How are we implementing principles-based regulation in practice?	23

Ten point summary

- Principles-based regulation will sustain the current rigorous regulatory environment for UK financial services, but with better and more effective outcomes.
- Over the next few years we will move to more principles-based regulation, supplementing our risk-based and evidence-based approach. This is a continuing process, which will require significant change of behaviour by both firms and the Financial Services Authority (the FSA).
- The balance of the FSA Handbook and our approach to supervision will rely increasingly on principles and outcome-focused rules rather than detailed rules prescribing how outcomes must be achieved.
- We will provide – either directly or through confirmation of industry guidance – a greater range of helpful and clearly sign-posted information to help firms plan their business processes and controls with confidence.
- We will invest in developing the capabilities of our people so that they have the experience, expertise, judgement and communication skills to make principles-based regulation work. We will also invest in improved online search facilities and enhanced knowledge management processes to give firms and our own people easy access to relevant information.
- We will measure our own performance against clearly articulated regulatory outcomes, using a wide range of metrics. Using the new Outcome Performance Report, this process will be integrated into the FSA's operations and governance.
- Firms will have increased flexibility in how they deliver the outcomes we require. Many will find a closer fit between meeting their business objectives and meeting regulatory requirements. Responsibility for key regulatory decisions will move to more senior levels, challenging firms' compliance, risk management and internal audit functions as they provide the necessary support to senior management and Boards.
- Well controlled and managed firms that engage positively and openly with us and the outcomes that we are aiming to achieve should expect to experience real benefits in the form of a 'regulatory dividend'.
- Principles-based regulation will achieve benefits for consumers by fostering a more innovative and competitive financial services industry. Principles-based regulation also offers effective protection as senior managers drive the changes necessary for their firms to meet the Principles. UK consumers can play a role in achieving this as, over the long term, they become more financially capable. We will work to see whether it is possible to achieve greater clarity about the respective roles of consumers and firms in achieving the right outcomes.
- There are constraints on how far and how fast we can move towards principles-based regulation, including the inevitable and proper establishment of precedent by the Financial Ombudsman Service (FOS) and the current preference of the EU Commission to adopt specific rules and regulations. We will continue to work actively with stakeholders and other regulators both domestically and internationally to make more principles-based regulation a reality.

1 Our regulatory approach

1.1 Introduction

The FSA is the UK's integrated regulator for financial services, operating under the Financial Services and Markets Act 2000 (FSMA). FSMA gives us powers to regulate individuals and firms engaged in business across the main sectors of the financial markets in the UK, including banking, insurance, asset management, capital markets and mortgage and general insurance mediation.

FSMA sets out our four statutory objectives:

- maintaining confidence in the financial system;
- promoting public understanding of the financial system;
- securing the appropriate degree of protection for consumers; and
- reducing the extent to which it is possible for regulated business to be used for a purpose connected with financial crime.

In fulfilling these objectives we are guided by a number of principles of good regulation. They require that we:

- operate with efficiency and economy;
- place proper emphasis on the role of senior management in meeting regulatory responsibilities;
- be proportionate;

- have due regard for and not stifle either innovation in the markets, or the international character of the UK's financial markets; and
- have proper regard to the impact of our regulation on competition.

We take a risk-based and proportionate approach to regulation, founded on the assessment of risks to our statutory objectives, taking into account the principles of good regulation. FSMA also requires us to be efficient and economic in using our resources, which means we need to prioritise our efforts and focus on the most significant risks. Underlying this prioritisation is an explicit recognition that, given the risks inherent in financial markets, a zero-failure regime is neither achievable in practice nor desirable in theory. In January 2000 we published *A New Regulator for the New Millennium* which articulated this approach and the operation of a risk-based regime across all our areas of responsibility. Since then we have further developed this risk-based approach, including through the development of an updated risk-assessment system in 2006.

When deciding on new policy initiatives, we take an evidence-based approach. We consider carefully whether there is a market failure which needs to be addressed and, if so, whether regulation is the best way to deal with the concern. In deciding whether to make rules, we examine the potential costs and benefits of such regulatory intervention.

We keep our regulatory approach under continuous review to ensure that the regime enables us not only to meet our statutory

obligations in an increasingly innovative and competitive marketplace, but also to remain up to date with international regulatory developments.

We believe that it is time for us to set out, in this paper, an updated approach to delivering our regime and operations.

The aim of this paper is to state what we mean by principles-based regulation and, where possible, to answer the questions and concerns that our stakeholders have raised. But publishing this paper does not mean that principles-based regulation is an immediate reality. We have already taken some important steps towards it, but much more remains to be done both by us and the firms we regulate. Moreover, there are some significant constraints on the progress and direction we intend to take. We will continue to engage with our stakeholders on how best to move towards a more principles-based approach over the coming years.

1.2 The move to more principles-based regulation

The shift to a more principles-based approach to regulation complements the risk- and evidence-based models outlined above. Risk-based regulation will remain central to determining how we prioritise our resources, as principles-based regulation steers our expectations of firms and the way we deal with them.

During the last year or so we have increasingly taken a principles-based approach to our activities, for example through our proposed new regime for the conduct of investment business, our Treating Customers Fairly initiative and our approach to addressing the market failure associated with policy documents not being issued on a timely basis in the wholesale insurance

market. Principles-based regulation is the natural next step in our development, allowing us to continue to improve the regulatory regime for the UK's financial services industry and consumers.

Principles-based regulation means, where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business. We want to give firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes we have specified. We will increasingly shift the balance of our activity towards setting out desirable regulatory outcomes in principles and outcome-focused rules, enabling our people to engage with firms' senior management in pursuit of these outcomes. We expect firms' behaviour, in turn, to change to adjust to this shift in emphasis. We will also measure and evaluate our own performance against identified regulatory outcomes.

Principles-based regulation is not new. Our 11 high-level Principles (the Principles) for firms have been in place since 2001 and most were present in the part of the former regulatory system overseen by the Securities and Investments Board. Over the last few years we have increasingly focused our supervisory and enforcement tools on looking at these Principles and the outcomes they describe. Even so, our current tools still rely heavily on a large number of detailed rules and often very specific process requirements. We will never get away from detailed rules entirely and believe they have an important continuing role in certain aspects of our regime. However, we see real benefits for firms, markets and consumers, as well as our own staff, in tipping the balance of our approach towards a greater reliance on principles and high-level rules.

In developing this more principles-based direction, we have already consulted widely, including with the Consumer and Practitioner Panels and the Smaller Businesses Practitioner Panel. We have also talked to over 60 Chief Executives during a series of meetings in early 2007. We will continue this discussion at our conference on more principles-based regulation on 23 April 2007. We remain keen to understand the views and concerns of all our stakeholders on this significant strategic initiative. Although this is not a formal consultation exercise, we welcome your views on principles-based regulation. Please send any comments for the attention of Verena Ross to MPBR@fsa.gov.uk.

The rest of this document outlines our plans for the realisation of principles-based regulation. In Section 2 we explain why we are making this shift, how it can be defined and what we believe the benefits to be. In Section 3 we consider the impact of this approach on how we set standards, engage with firms and measure results. In Section 4 we outline the key challenges for firms and ourselves in implementing principles-based regulation. Finally, in Section 5 we describe the key outstanding challenges posed by taking the route of principles-based regulation. In the Annex you will find an outline of some key milestones.

‘Principles-based regulation means moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business’.

2 Principles-based regulation

2.1 Why principles-based regulation?

Past experience suggests to us that prescriptive standards have been unable to prevent misconduct. The ever-expanding rule books of our predecessor bodies and our consolidated Handbook, designed to prevent misdemeanour, have not stopped further misselling, market misconduct or other detriment. Instead we believe that detailed rules have become an increasing burden on our own and the industry's resources.

Financial markets are constantly changing. Continuous innovation and new product development are important ways in which the financial services industry generates benefits for consumers and markets. It is important that regulation can respond rapidly to the pace of change in markets and so allow them to continue to develop for the benefit of their users. We believe regulation that focuses on outcomes rather than prescription is more likely to support this development and innovation. Any set of prescriptive rules is unable to address changing market circumstances and practices at all times, and it inevitably delays, and in some instances prevents, innovation. In a quickly changing marketplace, principles are far more durable.

The complexity of a very prescriptive regime with thousands of detailed rules is also likely to make it inaccessible to many firms' senior management. Particularly for smaller firms, who do not generally have access to deep compliance or legal expertise, the amount of detailed rules can be bewildering.

Finally, a large volume of detailed, prescriptive and highly complex rules can divert attention towards adhering to the letter, rather than the purpose of our regulatory standards. This would make it less likely that we will achieve our regulatory goals.

For these reasons, we believe that further enhancing our risk-based and evidence-based approach to regulation with an increased emphasis on principles and outcomes is not only the right but also the only way to progress our regulatory regime. We have already made some important steps in this direction. Progressively over the next few years we intend to do more.

2.2 What is principles-based regulation?

Principles-based regulation means placing greater reliance on principles and outcome-focused, high-level rules as a means to drive at the regulatory aims we want to achieve, and less reliance on prescriptive rules. Much of this rebalancing of our use of principles and rules has been and will continue to be executed through changes to the FSA Handbook and related material.

Principles-based regulation also means a different approach to how we deal with regulated entities, whether in the context of day-to-day supervisory contact, the information we request or, when necessary, the way we use our enforcement powers. It also means different expectations of firms and how they engage with the regulatory issues they face. Our aim is to focus more clearly on the outcomes we as regulators want to

achieve, leaving more of the judgement calls on how to achieve those outcomes to the senior management of the firms.

This does not mean we will be a purely principles-based regulator. In certain areas we will continue to need to rely on detailed rules and prescriptive processes to ensure adequate consumer protection or sufficient consistency and comparability between regulated entities, for example so that consumers can compare information provided by firms. Also, when implementing EU legislation, we might need to include more detailed rules in our Handbook. So in reality therefore there will always be a mixture of detailed rules and principles in our regime.

2.3 What are the benefits of principles-based regulation?

For consumers and investors, our belief is that our regulatory approach achieves outcomes that produce significant benefits both from more efficient markets and from firms better attuned to consumers' needs. We firmly believe this is the right direction for our regime and that it will enhance our ability to meet our consumer protection objective, as well as our other statutory objectives, going forward. It will allow us to deliver better regulatory outcomes in a proportionate way that is more efficient and effective.

We believe that, in many circumstances, the economic and business interests of firms' senior management and their Boards and shareholders can be aligned more effectively with our regulatory goals through a principles-based approach. In practice this means giving firms increased flexibility to decide more often for themselves what business processes and controls they should operate. This

greater alignment of business and regulatory objectives should in turn result in a more competitive and innovative market place.

However, an increased focus on the outcomes of regulation and more reliance on principles and outcome-focused rules does not necessarily mean that firms will find it cheaper to deal with the regulatory issues that they face. Rather, we believe that this regulatory approach will result in an industry that deals with regulatory issues in a more effective and efficient way. No longer will regulation be seen as a side-line occupation that imposes costs in addition and in parallel to business costs; it will be seen as an integral part of business decision-making. Because of its integration into consideration of how the business objectives can best be met, more principles-based regulation will mean more effective regulation for firms and for their customers.

'In a quickly changing marketplace, principles are far more durable.'

3 Impact of principles-based regulation

3.1 Changing the Handbook

We are committed to simplifying and shortening our Handbook. We are focusing particularly on those areas of the Handbook where the benefits of removing detailed rules seem to be greatest, and where other changes, such as the need to implement EU directives, offer us an opportunity to introduce changes with the least additional disruption and cost. Through this ongoing process of Handbook review, by the end of 2008 we will have reassessed rules that in total account for more than 80% of the administrative costs imposed on firms by our regulation.

We have, for example, already consulted on, and in some cases implemented, changes to the conduct of business rules and training and competence requirements. In changing these parts of the Handbook we have aimed, where possible, to discontinue detailed, process-orientated rules and have relied more heavily on high-level, outcome-focused principles and rules.

We recognise, though, that reducing the overall size of the Handbook, however desirable, does not in itself deliver principles-based regulation. Even a substantially reduced Handbook will still be regarded by many as a daunting prospect. We should therefore not measure our success in achieving principles-based regulation by the number of Handbook pages or the number of rules they contain, but by the effect that the Handbook review, together with other initiatives, achieves over time.

We believe we need to provide greater clarity about our expectations of firms, whether in the form of Handbook text or other material. We see a new regulatory architecture emerging that helps firms to understand the outcomes we want to achieve and provides practical examples and guidance to firms' senior management. Some of that help will not come through formal rules or guidance, but through industry solutions and guidance materials. Industry guidance has, for example, played an important role in moving our money laundering requirements away from prescription to higher-level rules, in unbundling the costs of other services charged as part of trade execution in institutional fund management and in delivering contract certainty.

Principles

Our 11 Principles for Businesses set overarching requirements for all financial services firms, and are themselves rules. Critically, they focus on what our regulations are trying to achieve and so are expressed in terms of outcomes and behaviours rather than processes or procedures. We do not intend to change the Principles or add to them: they still express clearly the actions and behaviours we expect from firms and provide the very backbone of our regulatory regime.

Principles for Businesses

1. A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10. A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. A firm must deal with its regulators in an open co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Being ready, willing and organised to abide by the Principles is a critical factor in our assessment of any firm, whether a new applicant or already authorised. Breaching the Principles may call into question whether a firm is still fit and proper. We believe that proper compliance with the 11 Principles is necessary, and in many cases will also be sufficient, to ensure the ultimate outcomes we seek to achieve for markets, firms and consumers will be realised. Breaching a Principle makes a firm liable to disciplinary sanctions.

High-level, outcome-focused rules

Whilst the Principles set out the highest level outcomes we are seeking to achieve, they still need to be underpinned with further rules. In essence this is the framework of the current regulatory regime. We intend to have fewer rules underneath the Principles and, where we decide rules are necessary to clarify or amplify, to express them in an as outcome-focused a way as possible.

Like the Principles, these rules will not focus on a specific process that a firm should undertake, but an end point that should be achieved. Also like the Principles, these are not entirely a new concept. For instance, the standard for financial promotions – that they should be ‘clear, fair and not misleading’ – has existed for a number of years.

These sorts of rules will not have a different status from other rules, nor do we plan to identify them separately in our Handbook. But by having these as a starting point for any regulation, they will help us to engage with the industry in a less prescriptive way that supports senior management responsibility.

Detailed rules will nonetheless remain a part of our regulatory toolkit. To some extent they will be required to implement detailed requirements in European directives over which we will not have any discretion (see Section 5). There will also be a range of scenarios in which detailed rules will be the most appropriate way for us to secure the regulatory outcome we require. For example, detailed rules might be suitable where the effects of firms’ behaviour are not readily observable or only observable over a very long period. Equally, we may find that a prescriptive approach is justified by the need to ensure consistency across an industry. For the purposes of consumer protection, for instance, we may continue to define the format and content firms must use to provide certain kinds of information to consumers, allowing easy comparability between different products.

FSA guidance and supporting material

If a firm has complied with the Principles, high-level rules and other rules, then it is irrelevant whether they have complied with any other material we have issued. But firms can rely on all the material we publish. This is fundamental to our approach. So if a firm takes a reasonable course of action which we have indicated, in

general public material or in a specific individual exchange (such as a supervisory letter), as being in compliance with a rule, then we will not take action against the firm for not having complied with the rule. The status of the general public material – the process it has been through, the format in which it has been published – does not affect that. For example, it does not matter whether it is a specific rule or formal guidance in the Handbook, or a case study or ‘Dear CEO’ letter on our website.

The Handbook sets out the minimum acceptable standards of firm behaviour and the primary function of the material we produce in support of it is to illustrate where the boundary of acceptable, compliant behaviour lies. We do not require firms to go beyond this level of compliance, although many do so for commercial reasons.

Of course, discussion of good practice can and does come up in our dialogue with firms and industry sectors about firms’ behaviour, and we will continue to engage with and foster this debate where we can add value. But in our discussions with, and communications to, firms about our requirements we will continue to focus on indicating where the minimum threshold of compliance lies (sometimes by pointing out good and bad practice) and to make clear that going beyond the minimum standard is a matter of commercial judgement for firms’ senior management and not a requirement of the FSA.

We will continue to exercise judgement on a case by case basis, within our legal framework, when it comes to deciding what status published material should have – that is, whether it is Handbook guidance or less formal supporting material. We will not simply issue Handbook guidance when a more dynamic approach (such as case studies or Dear CEO letters) would be more effective in achieving the outcomes we are looking for. This decision does not make a

difference from a firms' perspective to whether the material can be relied upon, but is a factor in the FSA's consideration of how much reliance to place on such material.

Our overall objective is to help firms make decisions themselves about what business processes and controls they should have in order to meet our requirements. In considering a firm's response to an investigation or other regulatory action we may look to material we have issued. The status afforded to our materials may impact the weight they carry in an enforcement context.

As well as consulting on guidance itself we will consider whether to undertake and consult on a cost benefit analysis of proposed guidance based on a number of factors:

- where we consider our proposed guidance may materially impact market structures;
- where it may change the behaviours of firms in a way which is not already accepted in the market; and
- where the guidance is not reasonably predictable from the Principle (without it being a new requirement).

Otherwise we will, when required by legislation, consult on guidance but we will not necessarily include a cost benefit analysis in the consultation (as will be possible following a Regulatory Reform Order coming into force later in 2007).

Industry guidance

To help firms determine how best to meet our expectations under principles-based regulation, we see a greater role for sector-specific guidance

and support provided by industry associations, professional bodies or groups of firms.

We published a Discussion Paper on industry guidance in November 2006¹ that aimed to help firms understand how they may make use of FSA-confirmed industry guidance and the reliance they can place on it. Firms are not required to adhere to any guidance, whether given directly by us or confirmed by us. However, case studies and other useful examples of how to meet our principles and rules, particularly when tailored to specific groups of firms, can clearly be helpful. We are keen to allow such industry support to be available to firms. If a firm takes a reasonable course of action that is indicated by FSA-confirmed industry guidance as being in compliance with a specific rule or principle (or part of it), we will treat them as having complied with that rule or principle providing that guidance was appropriate to them.

We should stress that it will be entirely up to practitioners and their representative and professional bodies to decide to what degree and in which cases they wish to take advantage of this opportunity to develop guidance material. We will need to work with industry associations to ensure the material we 'confirm' is available in a format that allows firms to access it easily and use it alongside any FSA material on the same topic. Where guidance has an impact on consumers an important factor will be how industry bodies have sought and considered the views of consumer representatives in the development of their guidance.

We will respond more fully to the feedback we received on our Discussion Paper in a Statement to be published in the third quarter of 2007.

1 http://www.fsa.gov.uk/pubs/discussion/dp06_05_newsletter.pdf

3.2 Changing how firms experience FSA regulation

Moving towards principles-based regulation has significant implications for how we work with firms on a day-to-day basis. Our own approach needs to be clearly directed away from attention to detailed procedural points and towards the regulatory outcomes. We are looking for firms to take greater responsibility for how they meet their regulatory obligations. This responsibility in many cases will be taken on at senior management and Board level, using the various materials that will be available and, where necessary, conversations with us. This represents a change in culture that challenges us as well as the firms we deal with.

Firms will see a difference in how we behave towards them. We will give greater recognition to firms' own management and controls and this will be reflected in areas such as capital requirements and supervisory intensity. Well controlled and managed firms that engage positively and openly with us should expect to experience real benefits from our more principles-based approach in the form of a regulatory dividend, for example relatively lower levels of regulatory capital, less frequent risk assessments, greater reliance on firms' senior management or a less intensive risk mitigation programme. There are clear trends in this direction at an international level, with the Capital Requirements Directive and the regulators' advice to the European Commission on Solvency 2, both directed at incentivising firms to invest in modern risk-management practices.

Contact with firms

Relationship-managed firms (that is, firms with a dedicated supervisory contact at the FSA responsible for the relationship with the firm) will have a supervisory team with the necessary skills

and knowledge to make sound judgements, based on good business understanding of the firm and the sector in which it operates. The supervisory team will be able to communicate clearly and effectively at different management levels of the firm, including the Board of Directors. To achieve this consistently, our Board has assigned a budget over the next three years to invest in the recruiting, developing and training of our staff. In addition, some of the changes we are making that particularly affect smaller firms, such as those related to regulatory returns, will also be felt by relationship-managed firms.

Most of the firms we regulate – about 95% – are smaller firms. The main contact these firms have with us is through the firm contact centre (which handles queries from firms without a dedicated relationship manager), information on our website, regulatory returns and occasional 'themed' visits (i.e. when we conduct a review on a particular topic). Over the next few years there will be significant change in how firms experience our interaction with them.

Firm contact centre

We will continue to expect firms to use their own initiative to find relevant material, but will be more willing than we have been to provide further information and support where firms have gone as far as they can on their own. There is a danger that we are seen as a free consultancy or that we answer questions where incomplete information has been provided. However, with a less prescriptive Handbook we are convinced that we must go further than we have been inclined to in the past in responding to firms' queries. We will need to work with firms and the practitioner panels to find the right balance in achieving this. Firm contact centre staff will be able to answer firms' reasonable questions on a timely basis and provide clarity and assurance around our expectations. That said, in an environment in

which we focus on the outcomes a firm delivers, firms will ask for our views on their detailed processes. We continue to believe that these judgements are for firms' management, not for us and there will be many questions of this kind that we will not be able to answer.

We will run a trial in the latter part of 2007 that will help us to identify how the effectiveness of call handling, and thus the experience of the firms, can be improved further. We will want to ensure that contact centre staff are as far as possible allocated to more complex queries on the basis of sectoral or topic experience.

The need to go further than we have done before in responding to firms' queries also requires highly effective knowledge management systems internally to enable easy access to and navigation of the body of relevant information about any specific issue. We are working to achieve these goals by the end of 2008. Specifically, during the second half of 2007 we will start to use tools to help our staff easily search and access the information we hold on a particular topic and the decisions we have made previously. This will help all our people to provide a better, consistent and more efficient service.

Making the Handbook and other information accessible

We know that for small firms in particular the amount of information we distribute can seem overwhelming, even if in practice most of it is intended to be helpful and supportive rather than mandatory. In 2006 we introduced a facility for firms to create their own Handbook targeted at their specific activities. We will be doing more to ensure that our website enables firms to identify and access all relevant material in as clear and helpful a way as possible. In 2008 we will launch a new facility on our main website and online Handbook which will enable

firms to find the material – amongst all that we publish – that is relevant to their business and to search it more effectively. This system will also enable users to subscribe to updates on particular topics that are relevant to them. Our website (and particularly the small firms section) will continue to be upgraded to make such information easily accessible.

Regulatory returns

Firms are obliged to submit regulatory returns so that we can review developments and focus our supervisory attention accordingly. Regulatory reporting helps us to reduce the burden of direct on-site supervision, while at the same time making sure that we can identify risks. We are reviewing the effectiveness of the regulatory reporting we request from firms in a number of sectors. We have published separately information on the impact that this work has had in generally cutting the data we request from firms. We are aware that reporting to regulators imposes significant costs on firms and so we are careful to require only the information necessary for us to be an effective risk-based regulator. As important as the amount of data we request is the fact that we are aligning our data requests as far as possible with the information that firms use for their own internal monitoring to meet their senior management responsibilities.

Firm visits

Firms we visit should expect to see us focus on regulatory outcomes. Although the teams visiting smaller firms will naturally not be as close to the firms' business as a relationship manager will be to a larger firm, all firms should expect our people to have a knowledge of their industry sector and general business practices. Our people should also be able to engage constructively with the firms' management, talking about regulatory outcomes and what they mean for the firm. Again

additional investment in recruitment, development and training of our staff will be important to achieving this.

Enforcement

Enforcement is a part of any regulator's toolkit. In our case it is a comparatively small but nonetheless important part of our overall regulatory strategy and approach. We have put significant effort in recent years into improving the efficiency and fairness of the enforcement process. We are committed to taking forward appropriate cases and demonstrating through those cases that our approach is proportionate, reasoned and legally justifiable. The Enforcement Guide² on which we have recently consulted explains this in more detail and contains the essence of our approach to enforcement in a more principles-based regulatory world.

The increased emphasis on principles and outcomes in an enforcement context is a development of our current direction rather than a fundamental change of course. Our Principles have the status of rules and we will, as we have always done, take enforcement action on the basis of a breach of them. Increasingly such action has been taken on the basis of the Principles alone, and this will continue. To do this, we are conscious that it must be possible for a firm to predict at the time of the action whether it would be a breach of a Principle. Some firms have expressed concern that principles-based regulation might lead to greater likelihood that we apply hindsight.

We do not believe such concerns are justified. As discussed above, supporting material and industry guidance will be more frequently produced and used in our move to regulating for outcomes, though in a risk-based way and not to replace

detailed rules. In an enforcement context, all such material is potentially relevant to an enforcement case. For example, it could speak to the question of reasonable predictability and it could inform the regulatory context at the time of the behaviour in question. Firms are not legally obliged to act on everything we say; only rules and Principles are binding. Where, however, firms reasonably rely on statements we have made – whether individual or generic and whether formal guidance or other material – in determining the approach they adopt, this will be a defence to any subsequent regulatory action we take. Firms' behaviour and positive engagement with the regulatory outcomes will also be a factor that is taken into account in our regulatory action towards that firm.

3.3 Measuring regulatory outcomes

We will need to be guided in our implementation of principles-based regulation by clearly articulated outcomes we want to achieve and against which we can measure and report our performance.

Over the last few years we have been increasingly explicit in all our activities to target and deliver regulatory outcomes that align to our statutory objectives. This is in particular driven by the three strategic aims that have provided a consistent framework for our activities since 2003 and which we envisage remaining in place for the foreseeable future. These are:

- promoting efficient, orderly and fair markets;
- helping retail consumers achieve a fair deal; and
- making the FSA a more effective organisation that is easier to do business with.

2 http://www.fsa.gov.uk/Pages/Library/Policy/CP/2007_02.shtml

To help us both to embed principles-based regulation and to track our progress in a structured and consistent way, we have now taken an additional step by defining nine outcome indicators, three under each aim, which are set out in the panel below. These explain what

success in delivering the three aims will mean in practice and will, over time, enable us to judge our achievement of that success. These indicators will increasingly drive our planning, decision making and operational activities.

Strategic Aim	Indicator number	Definition
Help retail consumers achieve a fair deal	1	Consumers receive and use clear, simple and relevant information from the industry and from us
	2	Consumers are capable and confident in exercising responsibility when dealing with the financial services industry
	3	Financial services firms treat their customers fairly and so help them to meet their needs
Promote efficient, orderly and fair markets	4	Firms are financially sound and well managed
	5	Firms and other stakeholders understand their respective responsibilities and mitigate risks relating to financial crime and arising from market conduct
	6	Financial markets are efficient, resilient and internationally attractive
Improve our business capability and effectiveness	7	The FSA is professional, fair, efficient and easy to do business with
	8	The FSA is effective in identifying and managing risks to our statutory objectives
	9	The costs and benefits of regulation are proportionate

These indicators are further broken down into a number of sub-indicators. We will measure our baseline for and progress towards each sub-indicator using specific metrics. In its first iteration, this new Outcome Performance Report, or OPR, has a total of nearly 100 metrics underpinning our analysis and illuminating the outcome indicators. There are different timescales associated with different metrics: for example, the financial capability survey will only be conducted every four to five years, while we report on service standards every six months. The number of metrics will be reduced in number and refined as we gain experience of their measurement and application.

Our use of the OPR is a key tool in sustaining the momentum behind our internal change to be more outcome-focused and principles-based. We will integrate the OPR into our routine management information so we can monitor regularly outcomes, risks, effectiveness, efficiency and economy. Our internal approach to measuring how successful we are in meeting our objectives is therefore closely mirroring the outcome focus that is driving our external regulatory strategy. We will publish further detail on the OPR in the next few months.

4 Implications and challenges arising from principles-based regulation

4.1 Implications for firms

While it is necessary that we make the changes to implement our principles-based approach, this is not in itself going to be enough to make this approach work successfully across the market. Firms must change their own behaviour and grasp the opportunities this presents for increased innovation and more flexible operations, while at the same time fully appreciating their regulatory responsibilities and ensuring that they deliver against them.

This will mean a shift in focus from managing a legally driven process of compliance with detailed rules to managing the delivery of defined outcomes in a more flexible regulatory environment. The corollary of having less prescription to deal with is inevitably that firms will have fewer certainties about what processes to have in place though there will be support in the form of FSA and industry guidance.

Working successfully in this landscape means Boards, Chief Executives and their senior management teams will need to engage in substance with the regulatory outcomes we want to achieve. They will need to work with us in a constructive way and exercise good judgement about how best their firm can deliver such outcomes.

Risk management, compliance and internal audit functions will need to support Boards and senior executives in meeting these challenges. Again, the focus of their work will shift towards satisfying themselves that processes and controls are suitable for the business being undertaken and the specified regulatory outcome. And they must ensure outcomes are monitored and reported in such a way that their senior managers and Boards can be assured that business ends are not being achieved at the cost of regulatory requirements. Effective compliance will evolve away from a primary focus on the designing, implementing and monitoring processes that embed detailed regulatory rules in business operations. Instead, it will increasingly require the exercise of judgement. This will mean a significant change in behaviour and management attention for many people in financial services firms.

We believe this will move the key regulatory decisions to a more senior level of the company and require Board Directors to engage substantively in managing the flexibility inherent in this approach. So managing regulatory risk will become much more akin to managing commercial business risks, in that sound judgement and effective implementation will be key to deliver the desired results.

We are well aware that many non-executive Directors cannot be expected to be experts in regulatory matters. As such, we appreciate that raising key regulatory judgements to the level of the Board presents new challenges to Chairmen and their Directors. Executive managers will need to help their Boards meet these challenges. This will place a premium on those with a real and deep understanding of the business, sound judgement, ethical integrity and strong communication skills.

Smaller firms

We recognise that there are specific challenges for smaller firms in dealing with principles-based regulation. In many smaller firms, much of the regulatory interaction will fall directly to the management and there is some concern in the industry that this increases the burden on these individuals.

We believe that principles-based regulation can work particularly well for smaller firms, where management is often on the front line and engages directly with customers. With such short lines of control and a deep understanding of their business, we think that it should be comparatively straightforward for smaller firms' management to grasp the outcomes we are seeking to achieve and to run their businesses accordingly.

For a principles-based approach to be effective for smaller firms, we will need to make it very clear to those firms what exactly it is that we require them to produce as outcomes. Where there is uncertainty we (or industry associations or professions) need to provide easy access to clear information and straight answers on the outcomes we are looking for. There will also need to be a change in the nature of the relationship with and service from the compliance consultants who have traditionally provided support to many firms – a change that must mirror the implications for in-house compliance professionals described above.

4.2 Challenges for the FSA

We recognise the task that we are asking our people to undertake in an outcome- and principles-based environment is much more demanding and complex than that of a few years ago. It is clear that, for this approach to work, firms must have more trust and confidence in the behaviours, competence and the judgement of our people. As we have heard from many of our stakeholders, this will be the acid test for the realisation of our regulatory approach. We are therefore taking steps to ensure that our people are equipped to meet this challenge.

Key to this will be improved recruitment, training, management and reward. In each of these areas we have made significant progress in recent years, but have further to go. On training, for instance, we successfully delivered substantial training to over 750 regulatory staff in 2006 on our Arrow 2 risk assessment model and the associated interviewing and feedback skills that effective use of this approach requires. Over the next three years we are doubling the amount we invest in training. Starting in 2007 we plan a comprehensive programme of training and development covering those working in areas ranging from policy to supervision and regulatory transactions, in addition to training and development for our contact centre staff referred to in Section 3.2 above.

To upgrade our staff's capabilities and fund the necessary investment in technology, we have – as we set out in our Business Plan for 2007/8 – set aside a total budget of up to £50m to cover non-recurring transition expenses. These include staff re-organisation costs, training and development and improving knowledge management. We anticipate that these transition costs will be incurred over three years, but with a heavy weighting towards the first 18 months. To avoid passing these costs on to fee-payers in a single

year we have arranged a borrowing facility, which will also enable us to release and deploy our reserves towards the funding of this programme.

Our intention is to recover the costs incurred in this transformation over a period of up to ten years, with a maximum impact of £5m (or 1.7%

of our annual cost) in any one year. We will provide an update to these estimates and explain the impact on our funding needs each year in our published Business Plan and budget.

‘Firms must change their own behaviour and grasp the opportunities this presents for increased innovation and more flexible operations, while at the same time fully appreciating their regulatory responsibilities and ensuring that they deliver against them.’

5 Key outstanding challenges and constraints

It is clear that principles-based regulation will present a number of challenges for firms and for us. As described above, we have clear plans to overcome most of them. However, from our conversations with stakeholders, and written and oral contributions to this debate, we recognise that, arising from our move to principles-based regulation, there are a number of important constraints that will remain, as well as challenges which will be particularly difficult to resolve. These are:

- impact of European legislation
- the framework within which we and the FOS interact
- articulating consumers' responsibilities, and
- dealing with greater uncertainty for firms.

European legislation

Together with the Treasury, we spend significant amounts of senior level resource to influence European legislators, policy makers and standard setters in order to achieve regulatory outcomes in Europe that are compatible with our approach to regulation. We are nonetheless conscious of the risk that future European measures could limit our ability to move further in this direction. To

counter this risk, we will continue to press forward the better regulation agenda, which is based on market failure analysis and appropriate impact assessment, in Europe. We have traditionally been effective in working with the Treasury in influencing measures coming out of European and global institutions, as we did in the case of clearing and settlement. We take this role very seriously and will continue to do our utmost to influence new measures at an early stage. In addition, we will continue to make the case for more principles-based and outcome-focused regulation, which is just as applicable in the EU and global context as at home.

We are encouraged by the European Commission's greater acceptance of better regulation concepts, but the fact remains that the Commission's main aim – as set down by member governments – is the creation of a single market for financial services. The Commission often sees maximum harmonising rules as the best way to create a single market. It also has an understandable concern that inconsistent interpretation of less detailed provisions across Member States can work against the creation of a single market. Depending on the extent of this, we could find EU-inspired legislation acting as a constraint on our aim to move to principles-based regulation. We recognise that, for some time to

come, the reality is likely to be that some quite detailed rules will continue to be incorporated in our Handbook through EU policy-making. This could at times run counter to our aim to focus on principles and outcomes.

The Financial Ombudsman Service (FOS)

While our role is to authorise and regulate financial firms, the FOS is the statutory dispute-resolution scheme, providing an independent service for resolving consumers' individual complaints about firms. FSMA makes it clear that the FOS is operationally independent of us, and that complaints are to be determined by reference to what is, in the opinion of the FOS, fair and reasonable in all the circumstances of the case.

Some firms are concerned that the move towards principles-based regulation will create greater uncertainty about what their obligations are to consumers, and that they may be held accountable for these by the FOS rather than by us. There is some concern that the FOS may interpret high-level rules and principles differently from us. This could limit the potential benefits from our move to more principles-based regulation.

It is important to bear in mind that most cases considered by the FOS turn on disputes of fact or on the application of general legal principles that apply to all businesses. This is unlikely to change as a result of our move to principles-based regulation. So we believe that it will also not change the FOS' role and its interaction with our regime.

However, we recognise that, where an individual FOS decision may have broader application to other cases, we need to continue to cooperate proactively with the FOS through our established

'wider implications' process. Through this process the work of the two organisations is coordinated, so that we can offer material to the FOS for their consideration and the FOS can obtain input from industry and consumer experts. We will continue to work closely with the FOS to make sure this coordination process works as effectively as possible.

The FOS has maintained the private dispute resolution approach of its predecessor schemes. It uses a regular newsletter to help firms understand its approach, both through general articles and summary case studies. The FOS is conscious that some firms ask it to publish more information to enhance its predictability, while other firms would view more detail as an additional layer of quasi-regulation. The FOS plans to commission an independent review in 2007 to examine, among other things, whether it is making the most effective use of the information it holds to improve the understanding of firms and consumers.

We are working closely with the FOS on principles-based regulation and are conscious of the links between these two workstreams. We believe, though, that greater transparency about the approaches both organisations are taking can be very helpful to firms.

Consumer capability and how they can help to achieve the right outcomes

An efficient retail market relies on capable and confident consumers as well as on firms who treat their customers fairly.

We therefore believe that consumers themselves can play a role in achieving competitive, innovative markets that also offer them effective protection. Our national strategy for financial capability will help enable consumers to take responsibility for

their financial affairs. However, firms need to be aware that, given the diversity of the UK's consumers, for some time to come poor levels of financial capability may continue to make it difficult for some to take on these responsibilities.

Through our Treating Customers Fairly initiative, we have worked towards firms becoming more sensitive to their customers' needs and requirements, so that as firms change their behaviour they can help consumers take more responsibility for their own decisions and help them to bear this responsibility effectively. This is, however, a complex and delicate challenge. There is a risk that firms will feel obliged to adopt a very low risk tolerance in their compliance, which might then compromise the delivery of the very goals we are seeking to achieve for the consumer and the economy as a whole.

We believe we should give this some further consideration. During 2007 we will want to discuss further with a wide range of consumer groups, practitioners and industry bodies how we might be able to tackle the challenge of achieving, where possible, a greater degree of clarity about the respective roles and responsibilities of consumers and firms in their dealings with each other.

Greater uncertainty

Firms need to be able reasonably to predict our reactions. If they engage positively with their regulatory responsibilities and can demonstrate they have taken all reasonable steps to achieve the right outcomes, we should clearly take that into account in our regulatory actions.

We know some firms are concerned that it will be harder to make these predictions in a more principles-based world. While we will be providing clarity about regulatory outcomes, firms will have less certainty about the detailed processes to achieve those outcomes as they gain greater flexibility. However, they will be able to place reliance on materials we publish or confirm.

We will work with firms to help them adjust and operate in this more uncertain environment by means of the actions we have outlined in this document, providing and signposting useful materials and enabling our staff to provide more helpful answers to firms' questions.

On this issue – as with the overall move to more principles-based regulation – firms will be looking to us to deliver on our commitments. By doing so we believe concerns will be alleviated and the benefits of this approach demonstrated.

Annex: How are we implementing principles-based regulation in practice?

Principles-based regulation will be delivered through a continuous process of change, both for us and for the regulated industry. Much has been done already. We have been working to deliver more principles-based regulation throughout 2006 and have made significant progress through reforming large sections of our Handbook. We have also made changes to our relationship management framework for the larger firms. In addition we have:

- worked with the industry to find solutions to market failures without introducing new rules – e.g. soft commissions and unbundling of costs in trade execution, contract certainty in the general insurance market;
- introduced principles for life insurers to help them calculate their capital on a risk basis, releasing some £4bn of regulatory capital in the UK life insurance industry;
- shifted the focus of our anti-money laundering guidance to outcomes instead of prescription, replacing 57 pages of rules with two pages of principles, supported by useful industry guidance;
- worked intensively with the industry on the Treating Customers Fairly principle and what it means; and
- removed detailed requirements that imposed costs on firms without commensurate benefits for the industry and consumers, such as working with the Department of Trade and Industry to remove requirements for small firms to have an external auditor. We have also lifted some training and competence requirements for wholesale firms and simplified some of our reporting requirements.

In the table below, we outline the areas where significant change is currently underway or planned. As you will note the main activity is planned for the next year or two, 2007 and 2008. Some further work might be necessary after this, and we will inform our stakeholders about those further steps through our future Business Plans (and where necessary consult through the usual consultation and discussion papers).

Issue	Timing
Treating customers fairly	Findings on firms' implementation to be published second quarter of 2007
Consultation on funds of unregulated collective investment schemes	Consultation second quarter of 2007
Consultation on permitted links rules	Consultation second quarter of 2007
Streamlined and simplified Handbook material on enforcement	Findings to be published second quarter of 2007
Publish Feedback Statement on industry guidance	Third quarter of 2007
Reviewing elements of regulatory reporting	Consultation in third quarter of 2007
Improving our internal knowledge management systems, rolling out a new search system	Third and fourth quarters of 2007
A new Conduct of Business sourcebook refocused to emphasise principles and high-level rules – about half the length of the old sourcebook	Implementation fourth quarter 2007
Simplified training and competence requirements	Implementation fourth quarter of 2007
Reviewing our conduct of business rules for general insurance business	Policy statement fourth quarter of 2007
Reviewing the depolarisation regime	Consultation paper fourth quarter of 2007
Changes to the financial promotions rules for investment business to provide greater flexibility for firms and refocus on the key requirement to be clear, fair and not misleading	Implementation fourth quarter of 2007
Review close links requirements	Consultation fourth quarter of 2007
Discuss with stakeholders how to tackle the challenges of consumer capability and responsibility	By end 2007
Reviewing our conduct of business rules for mortgage business	Publish findings first quarter of 2008
Review of Client Assets sourcebook	Consultation first quarter of 2008
Change the way our Firm Contact Centre responds to queries from firms so that we engage with them on their individual issues on the basis of a more principles-based approach	Implementation by April 2008
Launch a new content management system for fsa.gov.uk and the Handbook online	Second quarter of 2008
Changing the expectations we have of our people, our resourcing and people strategies so that we are better placed to deliver a different experience for firms	Implementation by fourth quarter of 2008

The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS
Tel: +44 (0) 20 7066 1000
Fax: +44 (0) 20 7066 1099
Website: www.fsa.gov.uk