



Financial Services Authority

# Reasonable expectations:

## Regulation in a non-zero failure world

September 2003

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## **Annex**

The Financial Services Authority publishes this paper primarily for information.

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# 1 Executive summary

- 1.1 The key purpose of the FSA's regulatory regime is to correct market failure. And with our risk-based approach to regulation, we direct our resources to those market failures that pose the greatest risk to our statutory objectives. Both of these aspects of our regime are derived from the Financial Services and Markets Act (FSMA)<sup>1</sup>.
- 1.2 However, we do not aim to prevent all failures of firms or all lapses of conduct. We commonly refer to this as a 'non-zero failure' regime. But while we have consistently stated that this is our approach and Ministers explained it in Parliament during the passage of the Act, it appears that this needs to be restated to consumers and commentators.
- 1.3 The Parliamentary Ombudsman's recent report into Equitable Life<sup>2</sup> noted, for example: "the fundamental mismatch between the nature and expectations of the prudential regulatory regime...and the understanding and expectations that policyholders and others appear to have had of that regulatory system". That view is supported by research that we have carried out (see 2.11).

## **Purpose of this paper**

- 1.4 This paper explains the thinking behind our non-zero failure regime and its implications for all of our activities. It does not develop new policy.
- 1.5 The paper is part of a wider project to raise awareness of the aims of our regulatory regime. In fact, achieving greater stakeholder awareness of the reasonable expectations of the regulatory regime is a strategic outcome in our Plan and Budget for 2003/04.

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1 The four objectives are maintaining market confidence, promoting public awareness, protecting consumers and reducing financial crime.

2 The Parliamentary Ombudsman, *The Prudential Regulation of Equitable Life*, available from [www.ombudsman.org.uk](http://www.ombudsman.org.uk)

- 1.6 We believe that greater awareness of the scope of regulation will also come through our consumer education work and our continuing liaison with consumer and trade bodies. This should result in more informed behaviour that will benefit all stakeholders.

### **How does a non-zero failure approach apply to regulation?**

- 1.7 A non-zero failure approach to regulation is implicit in the FSMA. The Act states, for example, that our consumer protection objective means ‘securing the appropriate degree of protection for consumers’. It also states that we must have regard to ‘the general principle that consumers should take responsibility for their decisions’. It does not require us to protect consumers from all risks (see Chapter 3).
- 1.8 The FSMA also sets out several principles of good regulation that guide us in achieving our objectives. These state that we should use our resources in an economic and efficient way, and should be proportionate in our actions. They also cover facilitating competition and innovation. Together with the objectives, these lead us to a regime that works with markets and is risk-based.
- 1.9 Consumers benefit from competitive markets. These provide lower prices, improved consumer choice and more scope for innovation. However, as Chapter 4 shows, markets can fail and this provides the reason for regulation. We are committed to correcting many forms of market failure, including those that affect the financial system as a whole. And to date, the costs of firm failure in the UK have been small compared with those experienced in many countries.
- 1.10 But in competitive markets unsuccessful firms may fail. The possibility of individual firm failure is not a sign of market failure nor is it a sign of regulatory failure. If all chance of failure was removed, stakeholders would have no incentive to exercise caution, safe in the knowledge that we would always protect them. This might offer some reassurance in the short-term but over time this would increase the likelihood of more significant failures.
- 1.11 Alan Greenspan, the Chairman of the Federal Reserve Board, discussed the role of bank regulation in 2001: “To survive and be effective, banks must be willing and able to take risk. Revenue, shareholder equity, and if necessary the Bank Insurance Fund are there to deal with mistakes. Put differently, while public policy needs to limit the financial and social costs of bank failures, we should not view every bank failure as a supervisory or regulatory failure<sup>3</sup>.”

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3 Remarks by Alan Greenspan at the conference of state banking supervisors, Traverse City, Michigan, May 18, 2001.

4 Regulation in a non-zero failure world (September 2003)

- 1.12 In addition, direct regulation is not the only form of protection available to consumers. Within the UK, consumer loss can also be mitigated by the availability of compensation through the Financial Services Compensation Scheme and the possibility of redress through the Financial Ombudsman Service. We also work with H. M. Treasury and the Bank of England to preserve financial stability.

### **Regulatory processes and outcomes**

- 1.13 We seek to meet our objectives in a world of imperfect information and with finite resources. We need to make judgements and set priorities. Our earlier publication, *A new regulator for the new millennium (NRNM)*, contained a set of challenging standards for assessing whether our regulatory judgement had been used correctly in any given case (see 5.2).
- 1.14 Where a regulatory decision is needed, there is often more than one course of action open to us. A decision has to be based on the information available at the time. Stakeholders have a right to expect that regulators will make decisions carefully, consistently with the legislation, and based on a reasonable assessment of the facts. With the benefit of hindsight, this may not always result in the best outcome. But as long as the decision was reasonably reached, that may not represent a failure of regulation.
- 1.15 With our risk-based approach, we have to target our resources to those tasks that pose the greatest risks to our objectives. We have therefore developed a framework for allocating resources against risks according to their probability and possible impact on consumers, to minimise the risks to our objectives (see Chapter 6).

This paper will be of interest to a range of stakeholders, particularly those with a consumer focus.

Non-zero failure has the potential to affect all users of financial services and purchasers of financial products. It also has direct links to our consumer protection and consumer awareness objectives. So, a better understanding of why we do not aim to eliminate all failures of firms or lapses in conduct may lead to more prudent behaviour by consumers. This in turn may reduce the possibility of consumers suffering losses in the future.

# 2 Introduction

- 2.1 In *A new regulator for the new millennium (NRNM)*<sup>4</sup> we said that we would aim to maintain a regime that “ensures as low an incidence of failure of regulated firms and markets (especially failures which would have a material impact on public confidence and market soundness) as is consistent with the maintenance of competition and innovation in the markets.” This paper sets out in more detail the rationale for a non-zero failure regime, in the context of our market-based approach to regulation.
- 2.2 In stating that our regime is market-based, we mean that our regulation is directed at correcting market failure and using markets to help us achieve our objectives. Where markets function effectively, we avoid constraining the actions of consumers or firms. And we have been consistent in this approach. In his 1998 Thornton Lecture<sup>5</sup>, FSA Chairman Howard Davies observed that “regulation, or any form of official intervention, is only justified in the presence of a substantial market imperfection, and where the cure is not worse than the original disease.” The implications of this approach and our use of incentives will be considered in more detail in a forthcoming FSA paper, *Harnessing Market Forces*.
- 2.3 Well-functioning markets are seldom static. Market processes are, over time, likely to result in firms entering or withdrawing from a sector. Withdrawal may arise as a result of firm failure. The financial services industry is no exception. So we cannot guarantee that any regulated firm will not fail. Similarly, unless we impose excessive costs, we cannot guarantee that there will be no lapses of conduct. If this is not widely understood, consumer expectations and those of other stakeholders may not match the reality of what regulation can reasonably achieve. Increasing stakeholder awareness about our regime may, however, encourage appropriately prudent behaviour. This, in turn, should help us to meet our statutory objectives.

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4 *A new regulator for the new millennium*. Financial Services Authority, January 2000, p6.

5 Davies, Howard, “*Why Regulate?*”. Henry Thornton Lecture, 4 November 1998.

- 2.4 Ministers have also viewed the FSMA as implying a non-zero failure regime. Speaking in Parliament during the second reading of the Bill, Alan Milburn (as Chief Secretary to the Treasury) said: “Protecting consumers does not mean absolving people of responsibility for their investment decisions. It is of course the job of the regulatory system to ensure that customers have sufficient information to make an informed choice. Consumers have a right to that, but it is not the job of regulation to provide a guarantee that nothing can ever go wrong; sadly, it sometimes does. That is the balance that the Bill seeks to strike -- a light touch where possible, and protection where necessary. The result will be a fair deal for the industry and for the consumer<sup>6</sup>.”
- 2.5 Predecessor regulators adopted a similar stance. The Bank of England, for example, as banking regulator, stated in 1997 that “The [Banking] Act [1987] accepts the possibility of bank failures and is not aimed at delivering a guarantee of banks’ deposit liabilities. To attempt to avoid any bank failing would be unhealthy for the economy (as it would involve limits on competition, innovation and the taking of risk, and increase the costs of supervision); it would also be virtually impossible to achieve. Rather, the intention of the Act is that effective supervision should so reduce the risk of capital loss to depositors, as a result of the imprudent management of authorised banks, that strong depositor confidence in authorised banks is maintained<sup>7</sup>.”

### **What do we mean by non-zero failure?**

- 2.6 Non-zero failure is often used to describe a regulatory regime that does not aim to remove all cases of firm failure (i.e. insolvency). This definition is relevant to prudential regulation, which seeks to limit firm failure through capital and other financial soundness requirements (the term prudential failure is also used). As an integrated regulator, we have responsibilities covering conduct of business, financial crime and consumer education as well as prudential rules. In this paper, we apply ‘non-zero failure’ more widely and consider various events that might have an adverse effect on our statutory objectives. But in each case the underlying question is whether – under the regime set by the FSMA – it is reasonable for us to prevent or mitigate such events. This paper shows the circumstances in which losses to stakeholders or other negative events do not imply regulatory failure.
- 2.7 While we use non-zero failure in this specific context, we recognise that other stakeholders may use the term ‘failure’ in other ways.

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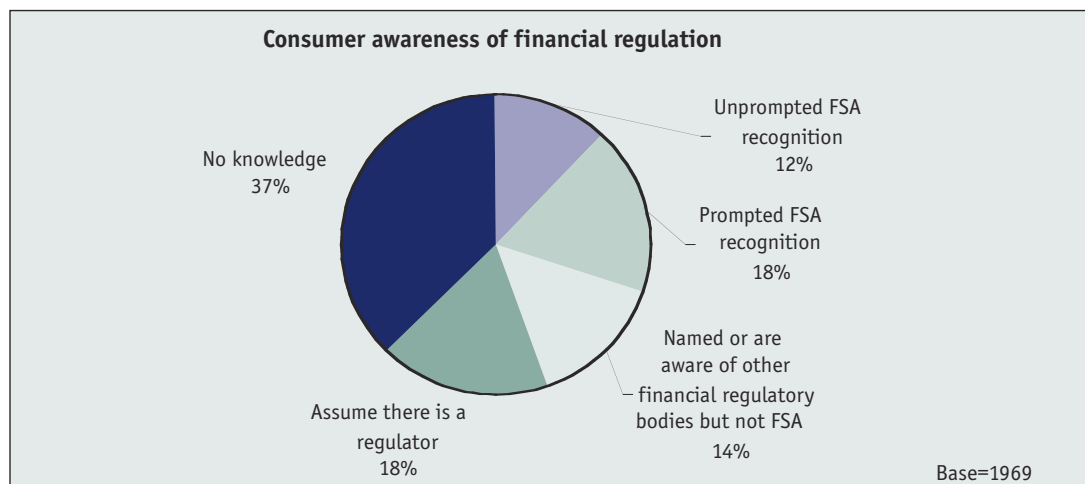
6 House of Commons Hansard Debates for 28 June 1999: column 40.

7 *The Objectives, Standards and Processes of Banking Supervision*. Bank of England, London, February 1997, p7.

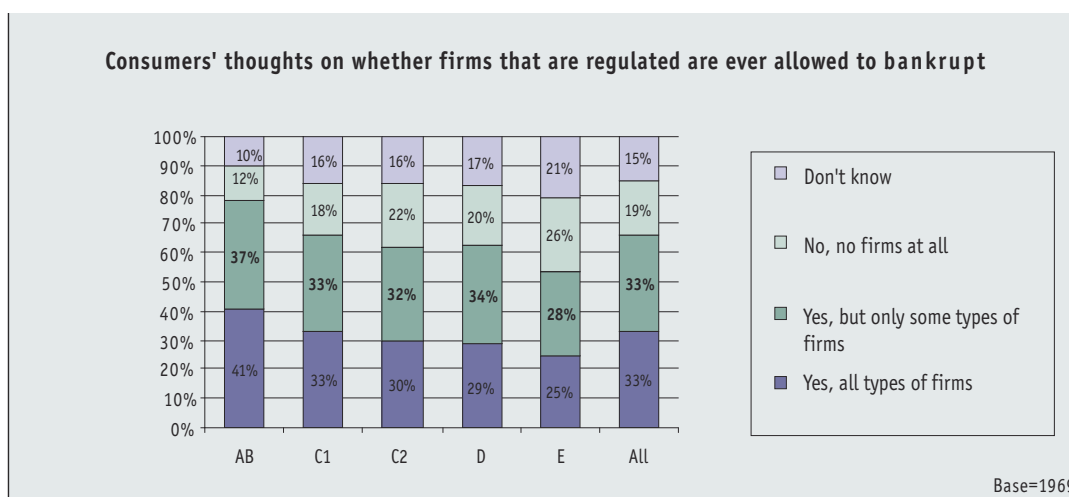
- 2.8 For **consumers**, failure could cover any financial detriment. This would include losses resulting from the failure of a firm. But it could also be widened to include the failure of a service or product to deliver what was expected (e.g. a reduced pay-out from a with-profits fund). There is a distinction to be drawn, however, between losses due to price changes that can be reasonably expected (e.g. changes in share prices) and those that result from market failure or wrongful behaviour (e.g. wrongful advice or misleading promotions). Regulation can limit cases of mis-selling but consumers need to take responsibility for cases of mis-buying (e.g. where a buyer makes an error of judgement when buying a product but is not misled).
- 2.9 For **firms**, insolvency is the most obvious form of failure as it leads to the demise of the firm and irrecoverable losses to shareholders (and we generally use 'firm failure' in this sense). But there may be less intense forms of failure at the firm level such as damage to the firm's reputation or closing for new business.

### The case for raising awareness

- 2.10 This paper is part of a programme to raise stakeholder awareness about non-zero failure. It is apparent that this aspect of our regime is not well understood by consumers, who may assume that regulation gives implicit or explicit guarantees against loss. The Consumer Panel, for example, in its Annual Report for 2002/03 noted that expectations of regulation may be higher than can reasonably be delivered. There is less of an expectation gap for firms. Financial service providers commonly create value for shareholders by taking on and pricing risks; the elimination of risk would undermine the basis on which they operate.
- 2.11 We recently conducted research to assess UK consumer awareness of the FSA and to test consumers' understanding of the possibility that regulated firms can fail. From the representative sample who were interviewed, 12% of consumers were able to name the FSA unprompted and a further 18% after being prompted (see the chart below).



2.12 A third of adults thought that all firms could go bankrupt, while 19% believed that regulated firms are not allowed to go bankrupt (see chart below). Another third said some types of firms only would be allowed to go bankrupt. The remainder did not know. The results varied considerably by socio-economic group, with 12% of those classified as A and B<sup>8</sup> saying that no regulated firms would be allowed to go bankrupt and 26% of those in socio-economic group E<sup>9</sup>.



2.13 These findings support our view that more work is needed to raise awareness of what we do and to explain our non-zero failure approach. This was already recognised in our regulatory plan for 2002–03<sup>10</sup>. The plan said that by 2005 we expect to have made progress on the strategic outcome that “stakeholders are aware that a risk-based regime does not imply aiming to prevent all collapses or lapses in conduct under the regulatory system.” In addition, we intend shortly to publish a paper outlining a strategy for financial capability which will represent a major initiative to improve consumer awareness. An understanding of the role of regulation and the responsibility of consumers will provide an important part of this work.

### International regulators

2.14 A market-based approach that recognises that firms may on occasion fail is far from unique to the FSA. The Basel Committee in a recent publication noted: “*Bank failures are a part of risk-taking in a competitive environment.*” Supervision cannot, and should not, provide an absolute assurance that banks

<sup>8</sup> Socio-economic groups A and B includes professional persons, senior and middle management and owners of small businesses and retired persons previously in such occupations.

<sup>9</sup> Socio-economic group E includes those entirely dependent on long-term state support or casual workers without a regular income.

<sup>10</sup> Plan and Budget 2002/03, Financial Services Authority, p27. The same aim has been carried-over into our Plan and Budget for 2003/04.

will not fail. The objectives of protecting the financial system and the interests of depositors are not incompatible with individual bank failures<sup>11</sup>.”

- 2.15 A US perspective was given last year by Peter Fisher, the Treasury Under Secretary for Domestic Finance: “The supervision of financial intermediaries...originates with the desire to avoid some set of bad outcomes: bank failures, depositor losses, fraud or some other form of consumer or social loss. The supervisory challenge is to limit these negative tail outcomes. To do so while still promoting competition and efficiency, however, requires that we recognise that individual failures are part of an overall system that produces both negative and positive outcomes<sup>12</sup>”. The Australian Prudential Regulatory Authority (APRA) too, has said that it does not aim for zero failure, but “seek to ensure that there are very few failures<sup>13</sup>”.

### Structure of this paper

The remainder of this paper is structured in the following way.

**Chapter 3** describes the statutory basis for our regulatory regime. It shows how the objectives and principles in the FSMA direct us to an approach that is market-based, proportionate and lead us away from trying to remove all risks to stakeholders.

**Chapter 4** explains how we try to meet our statutory objectives through correcting market failures. Such an approach provides us with numerous opportunities for protecting stakeholders. But not all losses incurred by consumers arise because of market failure. It shows that attempts to eliminate all potential for loss would have negative consequences for consumers.

**Chapter 5**, recognising that there are some failures we seek to prevent, sets out some further criteria for assessing whether in specific cases our actions can be judged to be reasonable. It shows that in promoting our objectives, we operate in a world of imperfect information. A decision has to be based on the information available at the time.

**Chapter 6** looks at how, in practice, we balance finite resources and competing priorities, given that there are resource implications to meeting our statutory objectives. This directs us towards a risk-based approach to regulation, which focuses our work on those issues that are the greatest threat to our objectives.

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11 Basel Committee on Banking Supervision, *Supervisory Guidance on Dealing with Weak Banks*. Basel, March 2002, p30.

12 Fisher, Peter, *The Future of Regulation and Supervision of Financial Intermediaries*. Remarks to the Federalist Society for Law and Public Policy Studies, October 2002.

13 Littrell, Charles, *APRA's Role and Approach to Regulation (under FSR)*. Speech given at LexisNexis Butterworth conference, Sydney, April 2002.

The **Annex** includes some case-studies that illustrate our non-zero failure approach. Each outlines a scenario where some negative event or potential threat to our objectives occurs. We then discuss whether our actions have been consistent with the approach to regulation in the FSMA. Some of the case-studies describe adverse events along with our response that we believe is consistent with meeting our statutory responsibilities. Others represent cases where we believe we could have done more to achieve our objectives.

# 3 The statutory basis for regulation

3.1 The statutory basis for our regime is contained in the Financial Services and Markets Act (2000) – (FSMA). Our work is aimed at achieving the objectives in that Act:

- maintaining market confidence;
- promoting public awareness;
- protecting consumers; and
- reducing financial crime.

3.2 These objectives direct us to prevent or mitigate a wide range of risks. They cover both prudential and conduct of business failures that may adversely affect market confidence and consumer interests. And they also direct us to other tasks such as increasing public understanding of the financial system, countering market abuse and reducing the extent to which financial crime occurs through regulated firms. The FSMA avoids, however, imposing a simplistic formula, such as requiring us simply to eliminate all risks to our objectives or to users of financial services without constraint.

3.3 This is illustrated by the consumer protection objective. The FSMA states that consumer protection means ‘securing the appropriate degree of protection for consumers’ rather than removing all risks. The Act also says that in considering what degree of consumer protection may be appropriate, we must have regard to:

- the differing degrees of risk involved in different kinds of investment or other transaction;
- the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;
- the needs that consumers may have for advice and accurate information; and

- the general principle that consumers should take responsibility for their decisions<sup>14</sup>.

### **The principles of good regulation**

- 3.4 In addressing its objectives, the FSMA says that we must have regard to certain principles of good regulation:
- the need to use our resources in the most efficient and economic way;
  - the responsibilities of those who manage the affairs of authorised persons;
  - the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits expected to result from the imposition of that burden or restriction;
  - the desirability of facilitating innovation in connection with regulated activities;
  - the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
  - the need to minimise the adverse effects on competition; and
  - the desirability of facilitating competition between those who are subject to our regulation.
- 3.5 The overall effect of these principles is to direct us to operate a regime that is both market-based (i.e. looks to market solutions) and risk-based. Above all, they reinforce the point that in seeking to reduce or remove risk, we cannot pursue our objectives in isolation from the wider economic context. As this paper outlines, there will be circumstances, consistent with the principles, where firm failure or conduct lapses occur but which do not represent regulatory failure.
- 3.6 The first principle, for example, recognises that our resources are finite. These are derived from fees paid by regulated firms, and will be reflected in the prices that consumers pay for financial services. But the number of regulatory actions we might undertake is potentially unlimited. Against this background, we must therefore decide how to use our resources in the most efficient way. As well as the direct financial cost, employing resources in a given function has an opportunity cost (i.e. resources devoted to one function are not available to another). This requires a rigorous process for determining priorities among the tasks we undertake (see Chapter 6).

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14 Section 5 (2), FSMA.

- 3.7 In the second principle, the FSMA stresses that we should expect a firm's management to be responsible for its activities and for ensuring that the firm complies with regulatory requirements. This guides us away from being unnecessarily intrusive and towards placing responsibility on a firm's management to adopt proper controls.
- 3.8 The principle of proportionality means that we have to assess the cost of any proposed solution against the benefits that are likely to result. It also requires us to assess whether lower cost options are available. There is also a requirement in the FSMA that proposed rules should be accompanied by a cost-benefit analysis<sup>15</sup>.
- 3.9 The fourth principle guides us towards actions that facilitate innovation by avoiding unreasonable barriers to entry or restrictions on firms launching new products or services. This principle is linked to the following three in that diverse and competitive markets are most likely to promote consumer choice and product development. The fifth requires us to consider the impact of overseas factors on the UK markets and consumers. It, too, is concerned with competition, making specific reference to the need to preserve the competitiveness of UK financial markets internationally.
- 3.10 The last two principles address competition directly. Their starting point is that competition confers benefits and therefore we should avoid unnecessarily impeding competition and should choose options that promote it where possible. This includes avoiding creating barriers to entry into markets. Under the FSMA, we can be challenged by the Office of Fair Trading if we fail to take account of the OFT's policies on competition.

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15 Section 65 (2), FSMA. The application of cost benefit analysis to financial regulation was considered by Alfons and Andrews in *Cost Benefit Analysis in Financial Regulation*, FSA Occasional Paper 3, Financial Services Authority, London, September 1999.

# 4 Market failures and the economics of regulation

- 4.1 In meeting our objectives in a manner consistent with the principles of good regulation, we have adopted a regulatory approach based on correcting market failure. But where the market is functioning effectively, we do not constrain willing buyers and sellers of financial services. There are, however, numerous cases where unregulated financial markets will not achieve the best outcome due to some form of market failure, making action on our part necessary. We will consider some of the ways in which market forces can be used to facilitate supervisory objectives in our forthcoming paper on *Harnessing Market Forces*.
- 4.2 Some discussion of the interaction between regulation and market processes is, however, necessary in the context of non-zero failure. This is to distinguish between two cases:
- Instances of market failure that can be corrected in a proportionate way through regulatory action; where action is justified to meet our objectives.
  - Situations where intervention to correct a perceived market failure would be disproportionate or interfere unreasonably with competition or have perverse effects; where the absence of regulatory intervention is a reasonable application of our non-zero failure policy.
- 4.3 The box below (taken from our latest Annual Report<sup>16</sup>) notes the benefits to consumers from effective competition and how markets may fail to deliver these advantages.

The main economic justifications for financial regulation are information asymmetry and externality. Information asymmetry refers to situations in which one party to a contract has significant information advantages over the other. For example, a consumer buying a packaged investment product might have little information about the underlying investments or about the competence of the fund manager. Externality refers to situations in which the parties to a contract have insufficient incentive to take

16 FSA Annual Report 2002/03, p105.

into account the costs that their activities might impose on others. For example, a large bank trying to secure high returns for shareholders might take on very risky loans without considering the public costs that would arise if the loans were to go bad and the bank itself fail. Information asymmetry and externality (and, in some contexts, monopoly) are considered to justify regulatory intervention because they make it difficult for the market by itself to deliver the socially optimal outcomes. Thus they are often referred to as 'market failures'.

Where competition is effective, consumers as a whole will be offered a variety of products that reflect their true preferences, and the prices of those products will be roughly equal to the all-in cost of producing and supplying them. Individual consumers will select or be guided to the specific products that best suit their individual preferences. Where there are significant market failures, none of those outcomes is assured. Consumers may be faced with product ranges that reflect only low levels of investment in substantive innovation. Prices may greatly exceed the all-in cost, which leads to substantial welfare losses. There may be a serious mismatch between the products that individual consumers buy and their true preferences, which leads to a substantial reduction in consumer surplus.

- 4.4 As the text above notes, the case for regulatory intervention centres on the existence of two specific forms of market failure:
- **externalities** – the parties to a contract have insufficient or no incentive to take into account the costs that fall on third parties; and
  - **information asymmetry** – where one party to a contract has better information than the other (often where the purchaser of a product has less information than the seller or producer).
- 4.5 The following paragraphs examine how regulation can address these failures and the costs of overly restrictive regulation. The chapter then discusses how disclosure combined with the possibility of firm failure creates 'market discipline' and how regulatory guarantees against loss can undermine such discipline. Finally, it notes that regulation may wrongly be regarded as a largely cost-less activity, resulting in more regulation being demanded than can be justified on the basis of a true assessment of the costs.

### **Externalities and firm failure**

- 4.6 As noted above, firm failure can give rise to externalities. Occasional failures are consistent with the operation of a competitive market and may not require regulatory intervention. Some failures can, however, threaten financial stability and create a situation of systemic risk. Systemic risk has been defined as "the risk that an event (shock) will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial

portion of the financial system that is large enough to, in all probability, have significant adverse effects on the real economy<sup>17</sup>”. This could represent an acute form of market failure, at least in the sense that market forces could not readily correct this situation.

- 4.7 Systemic risk has most commonly been observed during banking crises, when concerns about the solvency of one institution have caused or threatened the failure of other firms. Solvency problems in the banking sector can result in contagion between firms due to exposures arising in the interbank market and through the payment system; depositors at sound banks may also try to withdraw funds immediately believing that these are at risk. The United Kingdom has not experienced major systemic events in recent decades and UK consumers and taxpayers have not incurred the costs that have fallen on the public in other countries. Such events are, however, relatively common globally. A recent World Bank paper<sup>18</sup> has identified 117 systemic banking crises in 93 countries that have occurred since the late 1970s, including eight in high-income countries. The costs of systemic failures can be very large. A study by the Bank of England<sup>19</sup> looked at 24 banking crises that occurred between 1977-2000. For the seven developed countries in the group, the fiscal costs of resolving the crisis amounted on average to 12% of gross domestic product (GDP) and for the 17 emerging market economies reviewed this rose to 17.5%.
- 4.8 A crisis of this type would represent a clear threat to our consumer protection and market confidence objectives but would also be a matter falling within the responsibilities of the Bank of England and H. M. Treasury. So, H. M. Treasury, the Bank of England and the FSA have entered into a memorandum of understanding to clarify respective responsibilities and to set out the arrangements for co-operation or liaison should a situation requiring urgent attention be identified<sup>20</sup>.
- 4.9 In terms of our own regulatory toolkit, we can limit instances of firm failure – particularly cases that might give rise to systemic risk – through the application of prudential requirements on a range of firms (including banks, insurance companies and investment managers). Such requirements, for example, aim to ensure that firms have sufficient liquid assets and capital to cope with funding difficulties or operating losses in normal circumstances, reducing the incidence of firm failure to an acceptably low (but not zero) level.

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17 Group of Ten, *Report on Consolidation in the Financial Sector*. Bank for International Settlements, Basel, Switzerland, 2001.

18 Caprio, Gerard and Klingebiel, Daniela, *Episodes of systemic and borderline financial crises*. World Bank, January 2003.

19 Hoggarth, Glenn and Saporta, Victoria, *Costs of banking system instability: some empirical evidence*. Financial Stability Review, Bank of England, London, June 2001.

20 The terms of the MoU are public and a copy can be obtained from any of the three participants.

4.10 But in limiting firm failure, prudential requirements need to be set in the context of our wider supervisory framework and the varying significance of financial firms to our objectives. As Chapter 6 describes, the intensity of supervision to which authorised firms are subject varies according to their potential impact on our objectives. A problem with a larger firm holding client funds is more likely to have a negative effect on market confidence and consumer protection than one with many fewer customers, an insignificant position in its market and which does not hold customer funds. We therefore expect to have a closer supervisory relationship with those firms whose failure would have the greatest impact on our objectives. This increases the likelihood that we can spot weaknesses (e.g. large exposure concentrations or weaknesses in controls) and take remedial action, limiting the likelihood of loss to stakeholders. Where we require firms to have capital, this is just one means of off-setting risk. It is also a residual means of addressing risks. Capital absorbs financial losses when they occur, whereas proactive management and supervision is directed to addressing and limiting material risks before they turn into losses.

### **Potential negative effects of very high prudential requirements**

4.11 Prudential requirements are an important means of limiting firm failure. At the same time, we are conscious that setting excessively high prudential requirements would have negative effects on the wider economy and raise questions of both proportionality and effectiveness.

4.12 One option that might be adopted in an attempt to eliminate risk would be to require firms to hold their assets in secure investments (e.g. government bonds). This would reduce their scope to invest in assets that have a greater element of credit risk or more volatile earnings but which, over the longer-term, may yield a higher rate of return (e.g. corporate debt or shares). As a result, lower earnings from investments would reduce the amount available to pay to depositors or other investors. Howard Davies referred to this issue last year: “It would be possible to reduce the risk of failure in the life insurance industry to something approaching zero by requiring all life companies to keep their assets in the form of cash and short-dated government obligations. In those circumstances there would be next to no liquidity risk and almost total certainty about future returns. Those returns, however, would be unexciting, limited to the risk-free lending rate, with a reduction for the costs of marketing selling and portfolio management<sup>21</sup>.”

4.13 As an alternative, a regulator might seek to raise capital requirements on firms to much higher levels than previously in an attempt to reduce the scope for

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21 Davies, Howard, “*Rational Expectations*” – *What should the market, and policyholders, expect from insurance regulation?* AIRMIC Annual Lecture, 29th January 2002.

firm failure to virtually zero<sup>22</sup>. If set at an excessive level, such a requirement might also result in unwelcome effects. Firms would need to pay dividends to compensate investors that provided the additional share capital. This could lead them to raise their risk profile in an effort to increase earnings, perhaps by moving into new and unfamiliar business lines, increasing the likelihood of prudential failure.

- 4.14 In addition to the effects on individual firms, a regulator attempting to remove risk from the financial system would also affect the channelling of household savings into corporate investment. Imposing very tight prudential controls that affect a range of institutions might reduce the return available to those who save through intermediaries (e.g. banks and life insurers) causing the volume of saving to fall. This could be off-set to some extent if savers turned to the capital markets and lent money to companies directly rather than doing so through intermediaries. But for some savers this might not provide a satisfactory alternative, resulting in a reduction in funds available for investment. This, in turn, would affect the long-term growth potential of the economy.

### **Information asymmetry**

- 4.15 Information asymmetry is another important example of market failure. Consumer welfare may be reduced if consumers do not have enough information to assess the quality and reliability of the products and services before them. David Llewellyn in the FSA's first Occasional Paper noted: "An informed judgement about the purchase of financial products and services cannot be made unless consumers know the true costs of the product, the precise nature of the product or contract, the basis upon which a financial product is offered (e.g. whether the firm is a tied agent or independent adviser), or what the benefit is to the agent (e.g. commission)<sup>23</sup>."
- 4.16 In the absence of regulation, this may be difficult to achieve. Financial products can be complex; they may, for example, have to deal with situations that could occur some years in the future. Expert providers will typically have an advantage in understanding contractual terms, compared with retail consumers, which they may wish to retain. Consumers, to the extent that they enter into long-term financial arrangements, are unlikely to test products through repeated purchases. And the performance of some products (e.g. annuities, pensions and with-profits policies) will depend on the continued existence of the product provider.

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22 In practice, zero failure could not be reached given the impossibility of setting rules to deal with every situation, including the risk of financial crime such as fraud.

23 Llewellyn, David, *The Economic Rationale for Financial Regulation*. FSA Occasional Paper 1, Financial Services Authority, London, April 1999, p23.

- 4.17 Addressing information imbalances is a means of protecting consumers. But as the FSMA states, in protecting consumers we need to take account of differing degrees of consumer experience and expertise. Professional investors and those with ready access to professional advisers will be at less risk from information asymmetry than the normal retail consumer.
- 4.18 Our recent work to improve the governance of life insurance firms, including making the use of discretion in with-profits funds more transparent, shows how we will use additional disclosures by insurance companies to assist retail consumers and their advisers<sup>24</sup>. Under the current governance framework for with-profits business, there are no specific requirements on firms to publicise how they use their discretion in the management of funds (including the smoothing of policy pay-outs and the calculation of terminal bonuses). With effect from next March firms must:
- define their principles and practices of financial management (PPFM);
  - make these publicly available;
  - give policyholders advance notice of changes in principles; and
  - publish an annual statement by directors on compliance with their PPFM.
- 4.19 This measure will help clarify to consumers what to expect when investing in a with-profits fund. While this area can involve some quite complex issues, the requirement to publish a PPFM will give analysts and commentators as well as consumers more access to information that will allow them to pass informed comment on the management of the relevant fund. This will help reduce information asymmetry in the insurance market. However, reduced with-profits pay-outs resulting from more challenging markets, such as lower investment returns and falling equity prices, are part of the normal market process. We can no more fix investment returns in this area than in any other. These depend on asset markets (e.g. share and bond markets) and the commercial skill of the product provider.
- 4.20 As well as requiring firms to disclose information, we play a direct role in providing consumers with information needed to make informed choices. We do this, for example, through consumer publications, alerts and comparative tables. On-going work directed towards providing better information to consumers is described in the FSA's Plan and Budget (2003/04). This included among other things:
- the completion of work to improve the quality of information about investment products that firms give to customers at the point of sale;

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24 Our proposals were outlined in Consultation Paper 167, *With-profits governance, the role of actuaries in life insurers, and certification of insurance returns*. Financial Services Authority, London, January 2003. A Policy Statement with the results of the consultation was published in June 2003.

- intensifying efforts to reduce the number of unclear and misleading financial promotions; and
- increasing the number of consumers accessing our on-line comparative tables.

## **‘Market discipline’ and ‘moral hazard’**

### *Market discipline and prudential failure*

- 4.21 Markets in which firms take commercial risks that can result in firm failure and where customers are aware of and respond to this are characterised by ‘market discipline’. In these circumstances, investors and other users of financial services have an incentive to consider the possibility of firm failure in entering into a transaction. This is likely to result in actions that limit or mitigate this risk (e.g. through diversifying financial assets or placing funds with more reputable intermediaries). So, the recognition that isolated failures can occur serves to prevent more serious instances of failure, including those that might be systemic or affect market confidence. But this depends on customers understanding this concept and acting accordingly.
- 4.22 David Mayes has reviewed a number of the key elements supporting market discipline and the means by which this could be increased<sup>25</sup>. He links market discipline to the need for greater disclosure by financial firms, making particular reference to the disclosure-based regime in New Zealand. In his view, which is directed to the banking sector (p26), a well-functioning market needs an active share market, good market analysts, rating agencies and an effective market in corporate control as well as effective competition. Such features do not prevent failure directly but provide market signals about whether firm failure is more or less likely, allowing customers to alter their exposures to firms and owners to take off-setting action if required. The diversity of the firms and markets that we supervise makes it difficult to apply a single disclosure model. However, increasing transparency can be a powerful option and links to our aim of reducing information asymmetry (see 4.15 – 4.20).
- 4.23 The importance of using market-related incentives is widely recognised among supervisors internationally. Reinforcing market discipline through disclosure, forms one of the three ‘pillars’ of the revised Capital Accord being advanced by the Basel Committee<sup>26</sup>. The Committee is encouraging market discipline by developing a set of disclosure recommendations which will allow market

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25 Mayes, David, A More Market Based Approach to Maintaining Systemic Stability. FSA Occasional Paper 10, Financial Services Authority, London, August 2000.

26 The Basel Committee on Banking Supervision is the leading international forum for setting bank capital adequacy standards. The Committee is currently finalising revisions to its Capital Accord, which will be implemented from year end 2006. The FSA along with the Bank of England is a member of the Committee.

participants to assess key pieces of information on, for example, the capital, risk exposures and risk assessment processes of banks. It has said that it “believes that supervisors have a strong interest in facilitating effective market discipline as a lever to strengthen the safety and soundness of the banking system<sup>27</sup>”.

### *Market discipline and conduct failure*

- 4.24 Conduct of business failure is different from individual firm or prudential failures. Some residual level of prudential failure, by reinforcing market discipline, is a necessary part of a competitive marketplace. However, lapses in conduct are generally negative from a consumer protection perspective. A market will operate more efficiently where both buyers and sellers have an accurate understanding of the products on sale (i.e. no information asymmetry). Lapses in conduct may, however, be a misguided response to short-term competitive pressures. But longer-term, conduct failures, once identified, can impose significant costs on firms as well. The pension mis-selling review that started in 1994 is now nearly complete and has seen over 1.1 million offers of redress totalling over £10 billion.
- 4.25 Should we therefore aim to eliminate all instances of mis-selling or other conduct lapses? In response to this view, there are two points to consider:
- First, it would be excessively resource intensive for us to try to prevent all conduct of business failures. This would, in theory, require us to monitor every sale made to a consumer, and would run counter to the principles of proportionality and management responsibility.
  - Second, it is not possible to prescribe the precise conduct appropriate for every circumstance.
- 4.26 Such considerations do not, however, dilute in any way from the strategic outcome that we have set for 2005: “firms and their management adopt strategies in respect of their customers that address regulatory risk, tailoring their products, selling practices, advice and training to deliver suitable products<sup>28</sup>”.

### *Consumer protection and moral hazard*

- 4.27 A regime that aims to eliminate the scope for failure through regulatory guarantees creates ‘moral hazard’: the danger that providing protection or insurance against an event occurring may increase the probability of that

27 Basel Committee on Banking Supervision, Consultative Document, Pillar 3 (Market Discipline). Basel, January 2001, p1.

28 FSA Plan and Budget 2003/04, p21.

event occurring by changing behaviour in a more risk-seeking manner. Rather than facing a non-zero failure world, consumers and others would operate in an environment characterised by ‘zero consequence’. Under this type of regime consumers would not need to establish the soundness of the firm with which they were dealing. Nor would there be any need to weigh up the reasonableness of the financial decision they were about to undertake. Consumers would be free to buy ever more risky products knowing that if these failed, they would not lose money. Similarly, if a system guaranteed that firms would be supported in the event of difficulties, management would also have a reduced incentive to be prudent.

- 4.28 Moral hazard has been debated extensively in respect of the provision of insurance for bank depositors against the failure of a bank and the provision of support for failing banks. As Goodhart et al note there is a balance to be struck: “Without a safety net, banks are subject to contagious runs; with full deposit insurance for small depositors and implicit ‘too big to fail’ guarantees, creditors have little, or at least reduced, incentive to monitor borrowers.<sup>29</sup>” Similarly, a World Bank study has found: “Thus according to economic theory, while deposit insurance may increase bank stability by reducing self-fulfilling or information-driven depositor runs, it may decrease bank stability by encouraging risk-taking on the part of banks.<sup>30</sup>” The form of public safety nets therefore needs to be considered carefully.
- 4.29 There has been considerable academic and policy analysis of the effects on high levels of deposit insurance in the context of the US savings and loans crisis. A large number of smaller US banks ran into difficulties during the 1980s and early 1990s. The eventual cost of the failure of savings and loans institutions and banks was estimated to have been around \$180 billion or 3% of US gross domestic product<sup>31</sup>. The US limited deposit guarantees to \$100,000 but in many cases the full amount was paid to depositors. The US savings and loans crisis has been attributed by some writers to the “moral hazard created by a combination of generous deposit insurance, financial liberalization and regulatory failure<sup>32</sup>” .
- 4.30 It is for these reasons that the UK has adopted a form of compensation based on co-insurance. The creation of the Financial Services Compensation Scheme (FSCS) recognises that consumers are at a potential disadvantage in terms of information when dealing with firms and need some form of protection. At the same time it retains some incentive for consumers to exercise their responsibilities. In the case of deposits, for example, the FSCS provides

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29 Goodhart, Charles et al, *Financial Regulation: Why, how and where now?* Routledge, 1998, p45.

30 Demirguc-Kunt, Asli and Detragiache, Enrica, *Does Deposit Insurance Increase Banking System Stability?* IMF Working Paper, International Monetary Fund, Washington, January 2000, p3.

31 Caprio and Klingebiel, see footnote 18.

32 Demirguc-Kunt, Asli and Detragiache, Enrica, see footnote 30

individuals with full compensation for losses of up to £2,000 and 90% of the next £33,000. For long-term insurance, the FSCS provides 100% cover for the first £2000 of a claim; above this amount, it provides 90% of the value of the policy in liquidation. Consumers are not compensated for losses in excess of the amounts covered by the FSCS<sup>33</sup>.

- 4.31 As a further form of redress, individuals that believe they have been treated unfairly by firms can contact the Financial Ombudsman Service (FOS)<sup>34</sup>. The FOS was set up under the FSMA to resolve disputes between consumers and financial service firms quickly and with minimum formality. It is an independent body, whose decisions are binding on firms (but not consumers) for cases involving amounts up to £100,000, although most complaints involve much smaller sums.

### **The 'public good' aspect of regulation**

- 4.32 David Llewellyn has written about the need for proportionality in regulation: “*Expectations about what regulation, monitoring and supervision can achieve need to be managed to realistic levels. There needs to be a recognition (including by consumers): of the limitations of regulation; that it has a limited role; that even in this restricted dimension it can fail; and that not all risks are covered. Above all, the optimum level of regulation and supervision falls short of eliminating all possibility of consumers making wrong choices in financial contracts.*”<sup>35</sup>
- 4.33 Like other public services, views will differ as to how much financial regulation should be provided by the state. This will be true even if it is accepted that the purpose of regulation is to correct market failure. But regulation imposes costs, whether measured in terms of direct expenditure by the regulator or the effect of rules on regulated firms. The direct costs of regulation are usually met by firms through fees paid to the regulator, as in the UK. While fees will normally be passed on to consumers as part of the price they pay for financial services, these costs are not likely to be readily observable by consumers. This holds more strongly in the case of the indirect costs of regulation. Individuals may demand very high levels of regulatory protection in the mistaken belief that it is a relatively low cost option from their own perspective. However, the costs can be significant; overly tight prudential requirements could reduce savings rates (see 4.14), while restricting entry into markets may reduce competition and innovation. In seeking to deliver reasonable regulatory outcomes, the FSMA requires us to consider carefully the likely costs of our actions.

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33 Details of the Financial Services Compensation Scheme can be found on its website at [www.fscs.org.uk](http://www.fscs.org.uk).

34 Details of the Financial Ombudsman Service can be found at its website at [www.fos.org.uk](http://www.fos.org.uk)

35 Llewellyn, David, *Principles of effective regulation and supervision of banks*. Journal of Financial Regulation and Compliance, vol. 6, No. 4, 1998.

# 5 Assessing regulatory outcomes

- 5.1 While we do not and should not aim to prevent all failures, there are financial and conduct failures that we do and should aim to prevent. In cases where we are unable to prevent them, we should respond to them effectively and efficiently. Such cases represent threats to our objectives that cannot be corrected by the market alone.
- 5.2 What then should our stakeholders reasonably expect us to achieve in preventing and mitigating such failures? To answer this question, we have set out standards that can be used by stakeholders to assess whether regulatory actions and outcomes are reasonable in a non-zero failure world<sup>36</sup>:
- the extent to which we have taken effective action to avoid risks to consumers by identifying and addressing issues pro-actively;
  - whether, in the event of a collapse of, or lapse in conduct by, a firm, we should have had prior knowledge of the circumstances leading to the event;
  - the impact of the event on consumers and the rest of the industry;
  - our response to the event, in terms of prompt and effective remedial action; and
  - the overall adequacy of our regulatory arrangements.
- 5.3 The first standard notes that we should be active in identifying risks and addressing them (the process for identifying and managing risks is outlined in Chapter 6). But we should not confine ourselves to dealing with firm failure or lapses once they have occurred, and should therefore look at emerging risks. This presents a particular challenge for us as a single regulator currently responsible for over 11,000 firms. In addition, the UK is home to a large and dynamic international financial centre that has extensive links with financial

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36 *A new regulator for the new millennium*, Appendix 3, p39.

markets globally. Many UK-based firms also have operations overseas. This produces significant benefits for the UK economy. But it also means that our statutory objectives can be influenced by more factors than would be faced by a regulator operating in a more domestically-focused financial system.

- 5.4 The next standard refers to what it is reasonable for us to know in advance about conditions leading to a particular event. Issues that could affect our objectives adversely will vary greatly in predictability and whether or not they form part of a complex chain of events. Some events that result in financial stress will be unpredictable and entirely beyond our direct control – such as the terrorist attacks in the US on 11th September 2001 or natural disasters. We will, however, be concerned with efforts to mitigate such high-impact events once they have occurred. And we will also be concerned with ensuring that, where appropriate, firms have adopted measures to control their risks (e.g. through contingency planning or stress tests). Other factors affecting regulated firms may arise from broader economic or social developments (e.g. an ageing population or changing legal environment). While we cannot directly influence these either, it is reasonable for us to assess the implications of these developments for firms and consumers where they are likely to have a material impact and to take mitigating action where necessary.
- 5.5 The impact criterion is linked closely our risk-based approach. In essence, the greater a specific threat to our objectives, the more regulatory attention it should receive. The impact of the event can be measured in several ways. These include:
- the number and type of retail consumers that are affected;
  - the scale of any losses; and
  - the availability of compensation or other forms of redress<sup>37</sup>.

These issues are also related to the next point (on response times) in that prompt and effective action is a means of limiting the impact of a risk on our objectives.

- 5.6 The last standard emphasises that an assessment of our approach may have to go beyond our response to specific events. It may, in addition, need to take account of the adequacy of our processes and how effectively we use all the available regulatory options open to us.

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37 See 4.30 and 4.31.

## Regulatory judgement

- 5.7 The standards taken from *NRNM* are linked to the issue of regulatory judgement. In our report *The future regulation of insurance*<sup>38</sup> we said: “Regulation is, above all, about judgement. In any given situation, our statutory objectives and principles of good regulation may in practice point in differing directions. The judgements we are called on to make are often particularly difficult in these circumstances.”
- 5.8 The principles of good regulation make clear that we must have regard to the responsibilities of those that manage the affairs of authorised persons. This means that those that manage firms are responsible for taking business decisions, including arrangements for ensuring compliance with regulatory requirements. To reinforce this point, we set high-level ‘Principles for Business’ on firms.
- 5.9 The first principle for business, for example, says that “A firm must conduct its business with integrity”. The second requires that “A firm must conduct its business with due skill, care and diligence”. Assessing compliance with these principles cannot be achieved through a ‘tick-box approach’, but instead requires supervisors to undertake a wider assessment.
- 5.10 Similar questions of judgement arise when we make a decision about a firm in difficulties. This must be based on how we can best meet our statutory objectives on the basis of the information available at the time. Allowing a firm to continue trading if its capital falls temporarily below its individual capital requirement (subject to a plan to restore the firm’s capital position) may involve less risk of loss to consumers than an automatic requirement to stop operations.
- 5.11 The latter option may worsen the position by provoking a sudden loss of confidence and/or may weaken (or remove) the possibility of the firm being purchased and re-capitalised. The absence of complete information means that some decisions may not, with the benefit of hindsight, lead to the best outcome. As the *NRNM* standards recognise, a judgement on how far we met our objectives has to be based on what it was reasonable for us to have known at the time, and the appropriateness of our action(s) in the light of that knowledge.
- 5.12 Such an approach contrasts with one where decisions are taken with reference to set points, against which action has to be taken. An approach based on set points might oblige a regulator to stop a firm undertaking any business should the firm fail to meet the conditions of its licence. There would be risks, though, in defining exactly when regulatory action has to be taken. Knowing that the regulator would close a firm should its financial position reach a

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38 *The future regulation of insurance*. Financial Services Authority, London, October 2002, p19.

certain point might tempt management to take greater risks (e.g. concealing their underlying financial position while seeking to trade out of their difficulty). The need to give regulators flexibility was therefore noted by the Basel Committee in their guiding principles for supervisors dealing with weak banks<sup>39</sup>.

### **Assessing regulatory outcomes**

- 5.13 *NRNM* included a number of short case studies that considered the question of whether we had met our regulatory objectives. The Annex looks in more detail at the way we exercise our judgement and the factors that should determine what stakeholders can reasonably expect from us as a regulator.

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39 Basel Committee on Banking Supervision, *Supervisory Guidance on Dealing with Weak Banks*. Basel, March 2002.

# 6 Risk-based resource allocation

- 6.1 An assessment of how we meet the standards set by the FSMA must also address our risk-based system of resource allocation. In other words, are we being proportionate in the use of our resources?
- 6.2 The principles of good regulation already direct us to this goal and this approach recognises that we are unable to commit resources to every potential risk or possibility of failure. Instead, we tackle those representing the greatest risk to our objectives. Some issues will be too small to justify us spending much time on them. If we did, we would be taking resources away from more pressing tasks, increasing the chance that more significant risks would be missed. To achieve this aim, we have developed a risk assessment framework to identify and quantify risks. This helps us determine the intensity of supervision for each firm that we authorise.

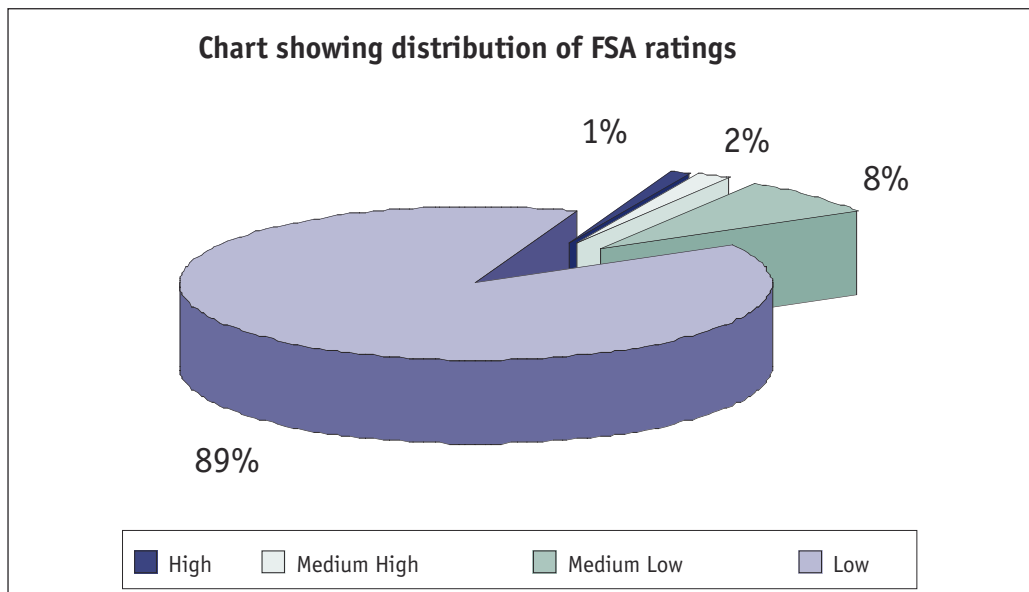
## **Risk identification**

- 6.3 There are three elements to our risk identification:
  - First, our framework for assessing financial institutions is designed to identify the material risks being incurred by individual firms and how these translate into risks to our objectives.
  - Second, some risks may extend beyond the firm-specific and relate to an industry sector or a large group of consumers. We examine potential risks falling under this heading through project work. This serves to subject topical issues to closer scrutiny.
  - Third, we aim to assess, within a single framework, the wider environmental risks that affect our objectives. These include external developments that can influence our ability to achieve our objectives (e.g. macroeconomic issues, market developments, social and demographic trends and financial crime threats). The results are published in our *Financial Risk Outlook* each year.

- 6.4 In each part of the risk identification process, we are concerned with the probability that a risk will arise and the impact on our statutory objectives if it occurs. The results form an important part of our annual Plan and Budget and affect the allocation of our resources.

### **Intensity of supervision**

- 6.5 At 31 March 2003, the FSA (with a staff of 2,288) was regulating 11,304 firms. The number of firms will increase by many thousands when we commence the regulation of mortgage advice in 2004 and the sale of general insurance products in 2005. The firms we regulate vary in size from individual practitioners to household names. To allow a risk-based approach to firm supervision, we group regulated firms into four impact bands (high, medium-high, medium-low and low) based on the potential impact to our objectives. We do not carry out a formal risk assessment on low impact firms. Material risks in this low impact group are picked up through regulatory returns, thematic work and other intelligence sources (e.g. complaints data).
- 6.6 Formal risk assessments that aim at identifying and mitigating firm-specific risks to our objectives are undertaken for all firms other than those judged to be low impact. These risk assessments aim to combine the impact that a firm might have on our objectives with a probability that such risks will occur. For those firms judged to have the greatest significance for our objectives, such as some high street banks and large insurers, we maintain a close and continuous relationship.
- 6.7 Under the risk-based approach, firms judged to pose least risk to our objectives receive much lower levels of regulatory attention than those in higher risk groups. Less contact with such firms, however, means there is less opportunity to identify firm-specific problems and take remedial action. But any individual firm in this group has a limited effect on our objectives. Consequently, they pose less of a threat to our objectives if they fail than a higher impact firm. Nonetheless, we do not say that firms in higher categories will never fail. And we recognise that problems arising across a number of smaller firms can have important implications for our objectives. As noted above, we address this through ‘thematic’ or cross-firm project work, which directs resources to issues or specific vulnerabilities affecting a group of firms.
- 6.8 The diagram below shows the allocation of firms between the various impact groups. The great majority of the firms are low impact and less than 1% of authorised firms have been assessed as high impact.



6.9 But it is not just in our day-to-day supervision of firms that we need to assess how best to use our resources. In fact, we have to make a similar assessment in considering other parts of our regulatory ‘toolkit’ (i.e. the options available for promoting our objectives). In the case of enforcement, for example, we could investigate and pursue a large number of cases. Each individual case can potentially be time-consuming and resource-intensive, particularly if cases are referred to the Regulatory Decisions Committee<sup>40</sup> and the Financial Services and Markets Tribunal<sup>41</sup>. So, we have to assess those risks that represent the greatest threat to our objectives as well as considering the likelihood of obtaining a successful enforcement outcome against the firms or individuals involved. We must also consider what alternative tools are available (e.g. consumer alerts).

6.10 Of course, if we had considerably more staff, firms could be monitored more intensively. And it is possible that, as a result, there might be fewer firm failures or conduct lapses. But, as outlined in chapter 4:

- extra regulation can bring extra costs and these will ultimately be passed on to consumers through the prices they pay for financial services; and
- the absence of market discipline creates risks, so efforts to achieve zero failure throughout the financial system will be frustrated over time.

40 Regulatory Decisions Committee (RDC) takes enforcement, authorisation and supervisory decisions that are of material significance for the firms and individuals concerned. RDC reports directly to the Board of the FSA.

41 Regulatory decisions are subject to review by the Financial Services and Markets Tribunal, which considers certain regulatory decisions afresh where there is no agreement on the outcome between the FSA and the firm or individual concerned.

# 7 The case-studies

- 7.1 In the Annex to this paper we discuss eight case-studies that show the practical implications of our non-zero failure regime. These will enable stakeholders to see whether their expectations of what regulation can deliver matches our own views.
- 7.2 Each of the cases illustrates an adverse event that affects one or more of our four objectives. They demonstrate that under our regime there will be instances where firms fail or consumers incur losses but that this does not, we believe, necessarily involve a failure to meet our objectives. But there are also cases where we think we should have done more to meet our objectives.
- 7.3 In assessing each case, stakeholders are asked to consider what was a reasonable action for us to take (in the light of the FSMA). As this paper has explained, the issue for us is not simply one of eliminating every regulatory problem. Instead we have to assess:
- the likelihood that risks will materialise;
  - what impact such risks will have on our objectives; and
  - whether to devote resources to addressing them.
- 7.4 Not all events that are failures from our perspective will have an immediate impact on consumers or indeed result in losses. Even so they can be failures against our FSMA objectives. So, while individual cases of money-laundering may not hit consumers directly or even have a visible impact upon firms, they are negative events from our perspective<sup>42</sup>.
- 7.5 The cases were discussed internally by FSA directors and heads of department. They used the standards contained in *A new regulator for the new millennium (NRNM)* to judge what was reasonable to expect of us in a non-zero failure regime (see 5.2). Their views about our performance are discussed within each of the cases highlighted in this paper.

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42 If weak money-laundering controls within a firm are indicative of wider management problems or lead to enforcement penalties, they can, however, pose risks to customers.

- 7.6 The cases are more detailed than those included in *NRNM*. But they are still quite short and are not an exhaustive account of all the factors leading to the risk event. Some were seen as relatively straight-forward by an internal audience; others hinged on an interpretation of certain facts. In some cases, minor changes to the facts presented in the central case would have produced a different result.
- 7.7 The case-studies demonstrate some of the challenges associated with operating a non-zero failure regime given differing stakeholder expectations. Reading the case-studies may help to provide a better understanding of what our FSMA-based regime can achieve.

# 8 Conclusion

8.1 The FSMA directs the FSA to prevent or mitigate many forms of market failure. But our non-zero failure regime also has its basis in the Act. There are several factors supporting this conclusion:

- We are required to secure the ‘appropriate degree of protection for consumers’ rather than to provide complete protection.
- The FSMA includes a general principle that consumers should take responsibility for their actions.
- The ‘principles of good regulation’ stress the importance of facilitating competition and innovation. While we seek to reduce the incidence of firm failure through our prudential rules, in a competitive market failure exists as the counterpart to competitive success. And occasional firm failures also reinforce market discipline and encourage customers to behave more prudently which reduces the likelihood of more severe prudential problems in the future.
- Finally, the principle of proportionality requires us to direct our limited resources to those risks that represent the greatest threat to our statutory objectives.

8.2 Firm failures and conduct lapses impose costs on stakeholders. We therefore continue to aim to ensure as low an incidence of failure as is consistent with the maintenance of competition and innovation in markets. Alongside this, it is important that stakeholders have realistic expectations of what regulation is able to deliver. This should put consumers in a position where they are better able to protect their own interests. We wish to aid consumers in this by providing information – either through firms or our own consumer publications – that will help them make informed decisions.

## **Implications for stakeholders**

- 8.3 This paper is relevant to various stakeholders including those with an interest in consumer affairs. To reach a wider consumer audience, the messages we outline here will also need to be delivered through other channels. However, we believe it is useful to draw together various statements that we have made on this subject and to explain in more detail what regulation can realistically achieve.
- 8.4 For some consumers the message of the paper may be an unwelcome one given the natural wish to avoid financial loss. The benefits of a market-based regime, such as greater choice and lower prices, may be assumed without further consideration of the competitive conditions that create this result. But in our view the overall position for consumers of having a market-based regime is a positive one.
- 8.5 Our goal in increasing awareness of our non-zero failure regime is to encourage a more prudent approach on the part of stakeholders, particularly consumers, and so reduce their chances of loss.

# Annex

- A.1 This Annex includes eight case-studies and a discussion of each of them. These are intended to cover all our objectives.
- A.2 Presenting cases such as these in isolation gives a partial picture of the issues we confront. At any one time, we will be wrestling with considerable numbers of firm and consumer related issues rather than focusing all our attention on one case at a time. Action in respect of any new or potential risk has to be weighed against the resources required elsewhere. However, they illustrate the diversity of the issues that we face and the decisions that we must take.
- A.3 Some of the case-studies are based around cases we have dealt with, while others are fictitious. Although more detailed than those in *NRNM*, we did not want to burden the cases with excessive detail. Some points are open to interpretation and we explore these. The cases were considered by several internal workshops of our directors and heads of department, who gave their view about the FSA's performance. We use the term 'senior managers' for convenience. More recently, we have presented the case-studies to various bodies representing external stakeholders. They have provided some useful comments but are not responsible for the views expressed here.
- A.4 For each case, the reader is asked to consider whether we acted in a way that was consistent with our FSMA-based regime. The criteria from *NRNM* may be helpful in coming to a conclusion (see 5.2). In each case we give the views of our senior managers about the case, although this was not a unanimous view in some cases.
- A.5 It should be emphasised, though, that the case-studies and accompanying commentary are provided for illustrative purposes only to show how we would assess whether we had met our statutory objectives. They do not constitute guidance under the FSMA nor should they be regarded as limiting the way that we may exercise our powers in the future.

## Case-study 1: Failure of a small bank

A small private bank with approximately 5,000 high net worth customers fails due to a worsening in the liquidity position which had been already been deteriorating for some time. The bank was late in submitting its quarterly liquidity report which showed the deteriorating position. This worsened rapidly after the report had been compiled. The bank had previously been rated as medium low impact (see Chapter 6). Under its risk mitigation programme, the bank's activities had not recently been reviewed by the FSA, though it was subject to baseline monitoring (e.g. statistical reports are provided and reviewed). The FSA had no other prior indication of the failure of the bank such as press reports or complaints. The failure of the bank is not judged to be significant enough to warrant invoking the memorandum of understanding with H.M. Treasury and the Bank of England as it does not involve systemic risk issues<sup>43</sup>. The FSA takes no action following the failure of the bank as it judges that the failure does not represent a significant risk to its objectives. The case attracts considerable press criticism as many customers are influential enough to secure coverage of their case. There are losses to the majority of customers due to the limitations of the Financial Services Compensation Scheme<sup>44</sup>.

- A.6 Debate on this case centred on the late submission of the report and whether a late report was sufficient reason for us to take action. There were also differing views as to whether a liquidity mismatch for a firm of this size should have been monitored more closely with action taken if necessary. One viewpoint was that we have insufficient resources to check every case where such a small firm faces deteriorating business conditions, nor would it be an effective use of these resources to do so. The existence of a liquidity mismatch is not necessarily a sign of impending failure (mismatches are usual for banks). The more relevant point was the scale of the mismatch and whether the bank was able to manage the problem.
- A.7 Overall, our senior managers felt, however, that in this case it was reasonable to expect the FSA to do better. The liquidity report was late. This should have prompted a reaction. The firm declined rapidly after the late submission of the report rather than before. But had we chased the bank for the report and the bank failed in the interim, the judgement would probably have been different (i.e. the FSA would have acted in line with its objectives, bearing in mind that this was a relatively small firm).

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43 Whether a situation represents a systemic vulnerability is dependent on the facts of the case.

44 The Financial Services Compensation Scheme will for deposits cover 100% of the first £2000 of loss and 90% of any additional loss up to £35,000. Those with high deposit balances at a failed bank may therefore lose a significant proportion of their total deposit.

## Case-study 2: Concerns about a small personal lines insurer that drops below its threshold conditions

A small UK-based motor insurer runs into difficulties through poor pricing strategies over a number of years. The insurer has approximately one hundred thousand private policyholders. The FSA has been kept informed about the problems at the insurer but is then informed that the insurer has dropped beneath its threshold solvency conditions (i.e. the minimum capital required as a condition of authorisation), falling some fifty thousand pounds short, a small percentage of its overall requirement. At the same time the FSA is made aware of a potential suitor for the company that is currently going through its books. The FSA decides, given the prospect of a takeover, that it will take no immediate action over the failure to meet the threshold conditions but continues to monitor the situation closely (i.e. it will not revoke its permission for the firm to operate). The FSA works with the two firms to ensure that should a takeover go ahead the change of control can proceed smoothly. The FSA also requests that the firm start to prepare a scheme of operations detailing how it will address its financial difficulties. The breach of the threshold conditions is rectified a month later when the firm is taken over by a larger insurer.

- A.8 This case-study is interesting as an example of the regulatory judgements that supervisors are required to make. Whilst firms are required to meet their threshold conditions (i.e. minimum conditions for authorisation), the FSMA allows us some discretion in enforcing this, to secure its regulatory objective of the protection of consumers (FSMA s. 41(3)).
- A.9 There were a number of suggestions why we could reasonably be expected to have done better. The first of these was that problems experienced by the company were long-term rather than a sudden development. We should have considered encouraging the firm to stop writing new business or to raise more capital. It was also suggested that the aggressive pricing policies should have rung alarm bells.
- A.10 The response to these points was that, in line with the principle of management responsibility<sup>45</sup>, it is not for us to make commercial decisions in respect of firms. The insurer may have made a commercial decision to win new business. This might have been a reasonable strategy for it to adopt. On balance, our senior managers felt it was reasonable for us not to have prevented the firm from trading when it slipped below its minimum capital requirement as there was a reasonable chance that this would be rectified shortly. The objective of protecting consumers was more likely to have been achieved by trying to ensure that the firm remained as a going concern rather than taking action which may have prevented the company carrying on in business.

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45 One of the principles of good regulation; see chapter 3.

- A.11 The question of what would have happened had the insurer not been taken over and had subsequently failed was also addressed. Here the view within the FSA was that as long as we had taken the decision to try to save the firm on reasonable grounds, but had proved unsuccessful, the failure should not be seen as a failure by us to reach our objectives. It would have been worth making this attempt even if it subsequently ended in the failure of the firm, as this was still the best way of protecting consumer interests.

### **Case-study 3: UK firm hit by problems from overseas parent**

A UK based trading firm is severely affected by the collapse of its overseas parent with considerable accompanying publicity. The parent has a number of related companies in the UK – one of which is regulated by the FSA. This is the leading trader on a London based market. This firm has a long history in trading on the market without raising regulatory issues, but was taken over by the overseas parent some eighteen months prior to the problems. The problems with the parent had materialised very rapidly and had not been anticipated by rating agencies or the UK firm itself. Its capital in the UK is ring-fenced with the parent unable to withdraw subordinated debt without the permission of the FSA. Whilst not selling directly to private individuals, its failure would cause considerable reputational problems and concerns in the market. The firm starts to experience problems due to perceived links with the collapsed parent, and as banks cut credit lines due to their exposures to the parent.

The FSA concludes that the firm is essentially viable despite the problems that it is experiencing and attempts should be made to assist it continuing in business. The alternative to this is an orderly wind-down of the business that would also require extensive FSA involvement. As part of this process, informal contacts are made with those banks cutting credit lines; as a result they are kept open. At the same time several parties express an interest in buying the firm. The firm is assisted in staying in business – so that it can be sold – by close liaison with the FSA to ensure that it continues to meet regulatory requirements. Preparations are made to ensure a smooth change of control process. The firm is not taken over and collapses.

- A.12 This case resulted in limited debate. The main question that arose was over whether trying to ‘ring-fence’ assets (i.e. trying to ensure that the UK subsidiary’s assets were not taken by the overseas parent) was the best means to ensure the security of its assets. Otherwise it was agreed that we did our best to address the situation in a risk-based manner; it was reasonable to make an attempt to keep the firm going, given its position in the market. We relied on other parties (such as banks who were prepared to extend credit lines to the firm) indicating that a market response was possible. It was relevant that there was little risk to consumers.

## Case-study 4: Failure of an internet stockbroker

An internet stockbroker, launched at the height of the dotcom bubble, runs into financial difficulties. It has approximately 50,000 accounts, not sufficient for its low margin business. It informs the FSA that it has breached its financial resources requirement, but hopes to be able to sell itself. The sale does not happen and the overseas parent injects enough capital to keep the firm going. The firm runs into the same difficulties a year later. Again a projected sale of the firm falls through and the parent injects enough capital to enable the firm to be wound down smoothly.

However the firm runs through the capital more quickly than expected. At this point the FSA faces a choice – whether to allow the firm to go into liquidation without taking any action or to facilitate a proposed transfer of the clients to a rival firm prior to liquidation. Normally such a transfer would be a lengthy process, but the FSA grants a number of waivers to enable the transfer to take place over the course of a week. This is on the basis that the company to which the accounts are being transferred has agreed to provide the same level of business and at the same rates. This enables clients to continue trading rather than waiting to have their funds unlocked by the liquidator. The firm applies to have its permissions removed by the FSA.

Not long afterwards, a third party service provider makes a formal complaint against the FSA. The supplier alleges that it partly based its decision to act as a supplier to the firm on the basis that it is regulated by the FSA, and the comfort it gained from the firm having to meet a requirement for three months of capital. It alleges that the FSA had been wrong in allowing the stockbroker to trade with less than the required capital.

- A.13 Here we believed that our actions were in line with what could be expected by a FSMA regime. The only issue was whether we should have ensured that the firm's clients were aware of the situation. The money belonging to clients was ring-fenced, so there was no possibility of clients losing should the firm fail. It was thought to be entirely reasonable to allow the firm to seek extra capital, particularly as it had a wealthier parent providing the backing. It was also agreed that in this context we do not owe a duty of care towards third-parties such as suppliers to regulated firms.
- A.14 The case did raise the point of what it means for stakeholders, especially consumers, when a firm is authorised. Firms are required to meet the threshold conditions, but there may be occasions when we judge that consumers' interests will best be served by allowing firms not to meet them. In other cases, it will not be apparent to us if that firm is not meeting its requirements, for example if the firm does not report to us that it has dipped below its threshold conditions between formal reporting periods. So, the fact that a firm is regulated cannot be an unequivocal guarantee of its financial soundness. Clearly, though, we would need to consider what action to take when we become aware that a firm no longer meets its requirements.

## Case-study 5: Collapse of a large hedge fund

A large, highly leveraged hedge fund collapses following unfavourable movements in the bond markets and worsening market sentiment. The fund is managed by a small UK based investment manager though a larger Swiss based company appears to be responsible for strategic management of the fund. The fund itself is located in a tax-efficient offshore location. The UK fund manager had been authorised four years previously and was able to demonstrate that it had the necessary systems and controls at the time of its authorisation. It is considered to be a low impact firm and was not closely monitored by the FSA.

The collapse of the fund causes losses for a small number of private investors in the UK who have been able to afford the minimum £100,000 investment required for the fund. It also causes losses for a number of corporate investors. The collapse of the fund also creates severe potential losses for its UK and overseas counterparties who are left with large numbers of trades that need to be unwound. Attempts are made in another jurisdiction to try to prop up the fund with some of the counterparties involved to permit a more orderly winding down of its business. These are not successful. The FSA visits the UK offices of the fund manager and concludes that its systems and controls for the activities that it conducted in the UK were appropriate and takes no further action.

- A.15 In this case we thought that our regulation of the firm had been appropriate. The question was asked whether we should have taken action to prevent the collapse of the fund, but it was agreed that it was unlikely that we could have done anything to prevent the collapse. The entity regulated by us had a role restricted to fund management. It dealt purely with the assets held overseas in the hedge fund and dealt solely with market counterparties. From our perspective, therefore, it was a low-risk entity (in terms of the FSMA objectives) and was rated as such. Although the collapse of the fund caused losses there were no issues of market confidence created by the isolated collapse of one fund. Nor was there any need to take action against the firm or its staff, as on both occasions that they were checked, the firm was able to demonstrate that it had systems and controls that were appropriate to its role.

## Case-study 6: Know your customer requirements

Inquiries into overseas money laundering reveals that some of the illegally acquired funds of a former South American head of state have been passed through three major British banks. This had taken place over a number of years until the individual's death earlier that year. The sums involved amounted to tens of millions of pounds and are now being claimed back by the country from which they were removed.

Further inquiries by the banks themselves, in conjunction with the FSA, reveal that the 'know your customer' requirements in the banks did not meet the FSA's requirements. Several of the transfers had been for large sums, the origin of which had not been fully

explained. These had been the subject of internal memos by bank staff querying their legitimacy in two of the banks, but due to poorly documented internal procedures and poor dissemination of these procedures, these concerns had never been relayed to the National Criminal Intelligence Service (NCIS). FSA staff had reviewed current anti-money-laundering procedures at two of the banks concerned in the past year but had not found any concerns during their review. The third bank was aware of internal problems with its anti-money-laundering procedures but had not informed the FSA of its problems. This bank's anti-money-laundering procedures were not due to be reviewed by the FSA until later that year as set out in the firm-specific risk assessment programme.

- A.16 Here, we had reviewed the procedures of two of the three banks through which the money had passed. The case-study leaves open whether or not this review was carried out through visits to the banks or through a desk-based review of procedures. An inspection at the bank would increase the presumption that we had failed to meet our objectives. One question that arose was whether we should have been reviewing high-risk accounts or whether we should have concerned ourselves with the systems and procedures in place at the banks. Some senior managers suggested that we should have looked at high-risk areas of the business and should have been asking about past 'bad' accounts. It was pointed out, though, that the accounts in question had been opened some time ago and so current procedures may have picked up the problems and therefore not been at fault.
- A.17 We believed that we were at fault as regards two of the three banks and had not achieved what might be expected of us. The two banks had poor procedures and failures of procedure and we should have spotted this. Views differed as to whether we should have spotted the problems with individual accounts – but the banks should certainly have had procedures to deal with high-risk customers. It was not possible to draw conclusions in respect of the third bank as we had not visited them or carried out a desk-based review of their procedures.

### **Case-study 7: Mis-selling of financial products to consumers causes losses to consumers**

The FSA had for some time been interested in high-income products and products that could involve higher levels of risk to capital than was apparent at first sight to consumers. It issued a general warning to consumers to be cautious when considering the purchase of such products.

Some time later, falls in equity markets and corresponding falling returns on financial products raise FSA concerns about investors and firms turning to high-risk products to try to raise their rate of return. The FSA launches a project to assess whether this is the

case and to assess the level of risk to consumers. The initial research identifies a particular problem with hedge fund based products that are just beginning to appear on the market. These are structured around hedge funds and located offshore, offering potential levels of return that are highly variable. The FSA issues a warning to both firms and consumers stressing the need to assess the suitability of the products based on each consumer's circumstances. As the FSA issues its warning, it becomes aware that a large chain of Independent Financial Advisers (IFAs) has already been selling unregulated, non-UK listed hedge fund based products to individual consumers. The FSA had been aware that the chain had been selling hedge fund based products to individuals but had been assured that this was to a very limited number of consumers all of whom met the FSA's requirements that they be experienced investors with a good understanding of the risks involved. It transpires, however, that the hedge fund based products had been sold extensively to private investors many of whom would probably not be regarded as sophisticated purchasers of such products. The investors had been assured that they were an extremely safe investment, but instead the products had produced disproportionately large losses for a number of the investors when compared with the falling values of other investments. Further inquiries with other comparable firms of IFAs reveal that a number of them have plans to sell similar such products. Several large product providers have started to bundle up hedge fund products and promote them extensively to IFAs as being low-risk investments suitable for private investors.

It is estimated that some 5,000 consumers had bought the products from the initial chain of IFAs, of whom several hundred had made losses. The chain previously had a good record of compliance. After the FSA takes up the issue with the chain it agrees to review all sales of hedge fund based products and to compensate those consumers who have lost. The FSA follows this with action against the individuals responsible for the mis-selling and for the inaccurate assurances given to the FSA. The FSA writes to other firms proposing to sell hedge fund based products pointing out the applicable conduct of business requirements. The firms re-assess their approach to selling these products in the light of the letter and the losses suffered by consumers.

- A.18 The chain of IFAs had breached our regulations by selling unsuitable products to consumers. They had not paid attention to the requirement that they take account of the sophistication of the consumer and provide products appropriate to their needs. However, the question over our performance centred on whether it was sufficient for us to rely on assurances given by senior management working for the chain. Other questions arose as to whether we should have been more alert to the potential problems that can arise when high-risk products are sold to consumers. We could, for example, have asked to see the promotional materials issued to investors. It was also suggested that the supervisory review of the chain of IFAs (i.e. the review

carried out as part of our risk-based approach to regulation) should have picked up the issue of the product mix and customers.

- A.19 Our senior managers felt, on balance, that it was reasonable to rely on assurances from a chain that previously had a good compliance record. It would probably not have been reasonable to rely on assurances had the firm not had a good record. We have to work on the basis of an element of good faith. Also, our actions after the event were appropriate as the consumers concerned were compensated and the individuals involved in the mis-selling were disciplined. There was also some discussion around whether we might have considered whether the original provider of the product had acted appropriately. For example had it misled the chain of IFAs in any way about the nature of the product and the risks involved? Any action on this issue might be hampered by the fact that the products were not UK-listed and the provider itself may be outside the scope of our regulation.

### **Case-study 8: Unregulated products being sold via the internet**

The FSA becomes aware through press reports of unregulated products being offered for sale to UK investors over the internet from overseas 'boiler rooms' (i.e. unauthorised entities undertaking authorised activities). The products offer exceptionally high returns that are in excess of anything offered by more mainstream domestic providers. Some 2,000 investors have subscribed to the products, investing a minimum of £5,000 at a time. The story reaches the press when a number of the investors discover that they are unable to cash in their investments and lose all of their money. The FSA issues a press release warning consumers about the dangers of buying such products and puts details of certain firms that have been associated with these activities on its website. The press release acts as a deterrent to a number of consumers, others however, continue to buy these products and a steady trickle of complaints reach the FSA and the press.

- A.20 Several suggestions that the FSA could have done more were examined. If we could identify the country from which the offer originated, we could have contacted the regulator in that country to see if action could be taken against the firms involved. Similarly if we believed that there was still money available in that jurisdiction, we could have made efforts to retrieve it. It was also questioned whether it is sufficient for us simply to publicise warnings about the risks of buying products from such unregulated companies.
- A.21 We believed on balance that we had broadly done what could reasonably be expected. The extent to which we had been successful in meeting our objectives depended on whether or not we contacted the overseas regulator (this is not stated in the case-study). However we had made efforts to alert people to the hazards involved in buying from these unregulated operations. There is a danger in alerting consumers to these risks that so many warnings

are issued that it blunts the message. There is, in reality, little we can do to protect consumers if they are determined to invest via such outlets, although we can try to ensure the availability of information. Consumers are able to check on the FSA website to see which companies are regulated. We also publish lists of unauthorised firms that have come to our attention. But it is likely that some individuals will continue to be attracted by the promises made by these sorts of firms even if warnings are delivered. Whilst we have objectives of consumer protection and consumer awareness, this does not remove the obligation for consumers to take responsibility for their own decisions.

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