The FSA: Risk and regulation

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What does the FSA do?

The Financial Services Authority (FSA) is responsible for regulating the UK financial services sector. And we promote the objectives set out in the Financial Services and Markets Act (2000) – or FSMA. That legislation requires us to:

- maintain market confidence;
- promote public awareness;
- protect consumers; and
- reduce financial crime.

To meet those objectives we try to reduce the incidence of failure of banks, insurance companies and other firms. We also try to tackle poor conduct by firms, increase public understanding of the financial system, prevent market abuse and reduce financial crime. Our overall aim is to maintain efficient, orderly and clean financial markets and help retail consumers get a fair deal.

Two of the FSMA objectives are about consumers (consumer protection and promoting public awareness). However, the FSMA does not require us to remove all risk from users of financial markets. For example, the consumer protection objective says that consumers should take responsibility for their financial decisions. So, it is important that consumers understand that regulation is **not** a guarantee against loss. We do not want consumers to have false expectations. But a better understanding of what regulation can, and cannot, do, should encourage consumers to take more informed decisions.

How do we protect consumers?

More generally, we believe that regulation is justified only if financial markets are not working properly. Where the markets do work effectively, we do not interfere with willing, informed consumers and firms entering into transactions. There are various things that we can do to make financial markets work more effectively. Two key things are:

- requiring financial intermediaries such as banks and insurers have adequate financial resources to conduct their business; and
- trying to close the information gaps for consumers that would occur in a non-regulated market.

Making sure that providers of financial services have the necessary financial resources in place is important to consumers. The value of many financial products – unlike other goods and services – depends on the seller's continued

existence. An example of this is where firms provide long-term savings products such as pensions, annuities and with-profits insurance policies. The same is true where customers put funds in a bank. The failure of the provider in these circumstances will result in a loss for the consumer.

Our conduct of business rules set out the disclosures that financial practitioners have to make when dealing with clients. For example, when they receive investment advice consumers must be told about commission levels and whether the adviser is independent or tied to a particular institution (e.g. a high street bank). Our rules also mean that firms have to manage any conflicts of interest that may arise between them and their customers. To inform consumers of these and other issues, we publish alerts and other communications for consumers. We also publish comparative tables (which are available on our consumer web-site www.fsa.gov.uk/consumer). And we operate a Consumer Helpline on 0845 606 1234.

Reducing information gaps reduces the possibility of mis-selling. By mis-selling we mean that a consumer is sold a product on the basis of misleading advice. But this should not be confused with mis-buying. Mis-buying occurs where consumers buy the wrong products, even though the risks have been adequately explained. Regulation cannot prevent mis-buying though consumer education can reduce it. Similarly, we cannot protect consumers against the effects of changes in market prices that are a normal part of market behaviour (e.g. losses arising from falls in share prices).

Why doesn't regulation try to prevent all problems in the market?

The idea that regulation should seek to eliminate all firm failures and conduct lapses may look appealing, but in practice this would impose significant costs on consumers.

Consumers benefit from competitive markets, where different firms try to meet their needs. This is recognised in the FSMA. Healthy competition in markets is likely to deliver:

- consumer choice – the range of products offered;
- higher returns on investment – as firms try to attract savers by offering higher returns;
- cost-effectiveness – as consumers can move to other providers, so prices are kept lower; and
- innovation – as firms compete to provide new products.

In a competitive market, firms that can meet consumer needs and control their costs are more likely to succeed. On the other hand, firms that are less successful in meeting consumer needs or that have higher costs, will be less successful. If they are unable to adapt to new conditions, they could make losses and may become insolvent.

Why can't regulators guarantee consumers against all losses?

Consider what would happen if a regulator or the state tried to guarantee consumers against loss. People would have an incentive to place their savings with firms offering the highest rate of return regardless of the risk that was involved, safe in the knowledge that they would be protected from loss should the firm fail. Meanwhile, in an effort to earn the highest returns possible for themselves, firms could invest these funds in risky projects safe in the knowledge that they would be saved from bankruptcy. This situation would rapidly become unstable and would eventually lead to a financial crisis. And while the UK has avoided the costs associated with domestic financial instability in recent decades, these have been very large in a number of other countries.

The possibility of firm failure means that firms and consumers exercise some care when they enter into transactions. This makes it less likely that major financial problems will occur.

In promoting our objectives, we also need to prioritise. With around 2,300 staff and more than 11,000 firms to regulate, we must also decide how to allocate our resources between various activities (e.g. supervision of firms, enforcement activity, consumer education, financial crime work). Given the many possible events that could have negative effects on the financial markets and our limited resources, we have adopted a risk-based approach to regulation. This means that our staff focus on the most important risks to our objectives. Inevitably, this involves a trade-off; resources devoted to one function are not available to work on another.

We have therefore developed criteria for judging which issues are more important and should account for more of our time and resources. In doing this, we look at the likelihood that a bad result will occur and at the impact that this will have if it does occur. So, issues that affect a larger group of consumers will therefore receive more attention than those that affect a few individuals, however regrettable these may be to the people concerned.

So what can the FSA do?

Effective financial regulation **can** reduce financial failure and conduct lapses below the level that would occur in an unregulated market. And, it **can** shield consumers from losses that would otherwise occur. It can also help consumers to make better decisions for themselves. But, it **cannot** eliminate risk. This is recognised in our legislation. If we tried to do so, we would remove the benefits that consumers gain from a competitive market place.
So, we need to achieve a situation where the responsibility for consumer welfare is shared between consumers, firms and the regulator.

What other forms of protection are there for consumers?

In addition to the work we do directly, other forms of consumer protection are available to consumers of financial services and products under the law.

The **Financial Services Compensation Scheme** (FSCS) offers compensation to investors, policyholders and depositors (details available from www.fscs.org.uk). The FSCS does not provide total protection. Depositors, for example, are 100% covered for the first £2000 and are 90% covered for the next £33,000. This represents an important safety net and we take the availability of compensation into account in taking regulatory decisions.

Individuals that feel they have been treated unfairly by firms can contact the **Financial Ombudsman Service** (FOS) (details available from www.fos.org.uk). 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 complaints up to £100,000, although most complaints involve much smaller sums.