

The Treasury Committee

Recent Turbulence in Global Financial Markets and Northern Rock's Liquidity Crisis

Memorandum from the FSA

1. This memorandum is submitted in advance of the FSA's appearance before the Committee on 9 October.

Recent turbulence in global financial markets

2. The turbulence which has characterised credit markets over recent months originated in the US sub-prime mortgage market but then spread much more widely in the financial system, with the contagion being fuelled by a fear of where the sub-prime risk now ultimately resides and a general loss of confidence in asset-backed securities and how they are rated. The chain of events leading from difficulties in the US to a tightening of credit markets globally and to serious problems in inter-bank lending in the UK is set out clearly in the note which the Governor of the Bank of England sent the Committee on 12 September. We would highlight one particular aspect of market developments in August and September: the disruption to credit markets in the UK and globally was partly due to a loss of confidence by buyers in high-quality commercial paper, leading to an almost complete and unprecedented disappearance of liquidity in the wholesale markets other than in the very short-term money markets.
3. In this Memorandum we summarise our regulatory actions over recent months, generally and in relation to Northern Rock. We explain how we worked with the Treasury and the Bank of England, within the Tripartite Framework, to respond to market developments and deal with problems in individual firms. Finally, we outline our plans to learn lessons from recent events.
4. To ensure that major banks at the core of the financial system remain sound and liquid, over recent months we have enhanced our monitoring of major market players by increasing the frequency of our monitoring of their liquidity and encouraging banks to take remedial action as appropriate. We have also assessed and dealt with threats to overall liquidity. This has included analysis of the funding and liquidity profile of the firms we regulate, including the obligations and implications of their involvement with Structured Investment Vehicles (SIVs) and Conduits. This also involved an assessment of the maturity and pricing profile of various instruments such as asset-backed commercial paper and other structured products, and their liquidity implications.
5. We have also collaborated closely with supervisors in other major financial centres to exchange information on developments in each centre, and to identify issues of common interest. From 9 August a daily, sometimes more frequent, discussion of developments has taken place between the Bank of England, the Treasury and the FSA.

Northern Rock's liquidity crisis: the FSA's response, and lessons to be learned

6. As the Committee will be aware from previous FSA evidence, our general approach is to regulate in a way which supports competition and innovation in financial markets. We believe that, overall, this approach has served UK financial markets well. We adopt a risk-based approach to our work; that is, we consider the impact on our statutory objectives (including consumer protection and market confidence) if particular problems were to arise in firms, sectors, markets or among consumers. We also consider the probability of such problems actually materialising. Taking these two factors together enables us to make a judgement on what priority to give to particular risks, and to allocate appropriate FSA resource to dealing with them. In competitive markets there will be failures; as we have said in the past, it would be impossible - and, in any event, undesirable - to seek to eliminate all risk from financial markets and to operate a zero-failure regime.
7. We had been concerned for some time that the impact of a severe tightening in global credit markets would be very significant. For example, in our 'Financial Risk Outlook' published in January 2007 we alerted firms to the need to consider how they would operate in an environment where liquidity was restricted, and we reminded firms of the need to incorporate stress testing and scenario analysis into their business models. On 19 July this year Hector Sants, on assuming his role as FSA Chief Executive, highlighted in a press conference following the FSA's Annual Public Meeting concerns about possible deterioration in credit markets. However, whilst we felt that a market correction was likely, we attached a very low probability to a tightening of the speed, duration and scale which we have just experienced. Our assessment was widely shared at the time by market commentators and analysts and by other banking regulators globally. However, it should be noted that we increased the intensity of our monitoring of credit markets in July.
8. Turning to the Northern Rock case, we supervise the firm in line with our overall risk-assessment framework. We carried out our most recent full risk assessment of the firm in the period December 2005-February 2006. Since this last full assessment, our supervision has included monitoring the firm's compliance with liquidity and other prudential requirements. We have also paid a number of visits to the firm to review particular aspects of its operations, including its arrangements for managing credit and liquidity risk and for stress-testing. In response to the firm's Pre-Close Period Statement on 27 June we increased our supervisory focus. Our reviews included giving feedback to the firm asking it to carry out more work on liquidity risk and the cash-flow implications of stresses on its securitisation programme. However, as noted above, we did not envisage, and the firm did not carry out, stress tests on a liquidity event as sudden and then sustained as the actual stress experienced this summer.
9. From early August conditions in credit markets deteriorated and Northern Rock experienced increasing difficulty in securing wholesale market funding other than on an overnight basis. We further intensified our monitoring of credit markets and considered the possible impact on individual firms. Therefore from 9 August onwards FSA senior management held daily meetings to review market conditions and the latest position of firms that were vulnerable to these market conditions. This increased supervisory activity covered all major market players and, since the market turmoil had originated in the US sub-prime mortgage market, from an early stage one area of focus was Northern Rock. We also took part in daily telephone calls with the other Tripartite authorities to discuss

the latest market conditions. In the period between 9 August and the end of September we held a variety of meetings with individual institutions, as well as three larger meetings (also attended by the Bank of England) with the CEOs of the major UK banks and UK institutional investors.

10. In order to mitigate the risk in Northern Rock's position we carried out work under three main headings:

- First, on 16 August we set up a Northern Rock project team working on: continuing supervision; liquidity support; a possible sale of the firm; and consideration of what would happen if the firm failed.
- Second, we actively discharged our mandate to seek private sector solutions. Clearly this is primarily the responsibility of the board of a listed company and its advisors. However, we contacted a number of potential purchasers during this period. The FSA had a number of discussions with one potential purchaser, but no acceptable structure was identified in the circumstances.
- Third, the company was continuing to investigate a variety of alternative funding strategies, notably the possibility of an underwritten securitised transaction.

By 11 September it became clear that private sector solutions, including securitisation, were not an option. During this period the Tripartite Authorities were also looking at public sector funding options.

11. As the relevant markets remained effectively closed, and the implications for Northern Rock became increasingly serious, we raised the position of the firm in the Tripartite Standing Committee. Following discussion in the Committee on 14 August, we formally directly notified the Treasury on 15 August of the position of Northern Rock. On 22 August the Tripartite Committee's Joint Crisis Coordination Team set up a working group, which included workstreams on the practical aspects of enabling the firm to borrow against a wider range of collateral, and triggers for the recommendation of such support. On 29 August the FSA Chairman wrote formally to the Chancellor, copying his letter to the Governor of the Bank of England. Our judgement was that the firm was systemically significant in the market conditions prevalent at the time. We discussed with our Tripartite partners, in particular the Bank, operational aspects and the potential provision of a lender of last resort facility at some future date. During this period we also monitored closely other institutions to identify any funding problems arising from the tightening in credit markets.

12. When it became apparent that a private sector solution was not available and alternative funding options were not materialising, discussions intensified within the Tripartite on the timing and terms of a facility. At the same time it became increasingly apparent that the company would need to consider updating its trading statement in the light of its deteriorating financial condition. The Chancellor, on the advice of the Governor and the FSA Chairman, authorised the Bank to provide a liquidity support facility and the company's proposed trading statement made reference to the provision of the facility. However, before any formal announcement from the company there was during the evening of 13 September media coverage of the prospect of such a facility being provided. On 14 September as part of a combined Tripartite announcement we confirmed our judgement that Northern Rock remained solvent, continued to meet its capital

requirements, and had a good quality loan book. On 17 September the Chancellor announced that the Government, with the Bank, would put in place arrangements that would guarantee deposits held with Northern Rock. The Treasury subsequently issued statements on the terms of that guarantee.

13. In the period from 14 September onwards we supported Northern Rock's communications with its customers by providing information, through our website and our Consumer Contact Centre, on the latest position and on steps which consumers could take.
14. It should be recognised that the key dependency for Northern Rock was not its use of wholesale funding per se. In terms of its net short-term wholesale funding to balance sheet asset ratio it was not a significant outlier in relation to other UK banks. Rather, its key dependency was its use of securitisation; its securitisation product was a simple one, based on high-quality assets. The market disruption did not affect Northern Rock's existing securitisations, but the market for new securitisations had largely closed. Neither did the market disruption lead to a cessation of Northern Rock's wholesale funding, but rather to a shortening of its duration and an increase in its price. The combination of these factors led the Northern Rock Board to seek assurance that contingency funding from the Bank of England would be available. The large retail outflows in mid-September led to a significant and sudden deterioration in Northern Rock's liquidity and required it to draw on the Bank of England facility. So it is clear that a combination of circumstances led to the position which Northern Rock is now in, rather than any single event.
15. Responsibility for Northern Rock's business lies primarily with its Board and management. But we recognise the great inconvenience and anxiety which Northern Rock's problems have caused for its customers, and the wide public concern and loss of consumer confidence occasioned by the unprecedented events of recent months. Despite the Government's safeguards for depositors, we are clear that what has occurred has been damaging. This is despite the fact that all depositors who have reclaimed deposits have been paid in full. As the regulator with a statutory duty to maintain market confidence and provide appropriate protection to consumers, the FSA needs to identify what lessons to learn, and what improvements to make.
16. As we note above, it is generally agreed that the disruption to credit markets we have experienced in recent months has been unprecedented. Yet it is already clear from our review of our supervision of Northern Rock before August 2007 that, whilst we understood the firm's business model and the attendant risks, our assessment of the probability of market conditions deteriorating as they did has proved incorrect.
17. We will conduct a review of the lessons which the FSA should draw from the Northern Rock events, and what changes these suggest for the FSA's risk-assessment and risk mitigation practices in general. We will publish the conclusions. We will wish to do this in a comprehensive manner, but it is already clear that the areas we will wish to examine (some of which were being worked on before the events of Northern Rock) include:
 - the extent to which the FSA's framework for assessing risk within firms should place further importance on liquidity issues;
 - whether changes should be made to the FSA's liquidity regime, and the interrelationship between the UK's and other countries' liquidity regimes;

- the strengthening of stress-testing within firms, and the challenge to this from FSA supervisors; and
 - the continuing strengthening of the FSA's supervisory resources.
18. Recent events have also raised questions about the adequacy of current deposit protection arrangements and their interplay with the lender of last resort function. The current system for deposit protection is operated within the framework established in 2001 under the Financial Services and Markets Act 2000. The Financial Services Compensation Scheme (FSCS) covers customers of all authorised financial services firms, including banks and building societies. The FSA is responsible for setting the rules within which the FSCS operates, including on eligibility of claims and compensation limits. Since 2001 it has dealt with a wide variety of firm failures and has paid out more than £950m in compensation to consumers. The FSCS is funded through levies on the industry and is free to consumers at the point of use.
19. The FSCS's main function is consumer protection: it provides consumers with a measure of compensation in the event of failure of an institution in the financial sector. The existence of a compensation scheme helps to reduce the systemic risk that a single failure of a financial firm may trigger a wider loss of confidence. But while it contributes to encouraging consumer confidence in the markets, the FSCS was not designed, on its own, to be able to deal with all potential failures of financial firms, nor to be a crisis management tool in the event of a large-scale failure.
20. However, in the light of recent events we decided it was necessary to act to reassure depositors and so, as a first step, we announced on 1 October, with immediate effect, that we have increased the FSCS limit for deposits to cover 100% of each depositor's claim up to a limit of £35,000. The previous maximum payout was £31,700 – 100% of the first £2000 and 90% of the next £33,000 of depositors' eligible claims. The EU Deposit Guarantee Schemes Directive provides a minimum compensation for depositors in member states of €20,000 (around £14,000). Member states can limit compensation to a percentage of deposits but can not limit it to less than 90% until €20,000 has been paid.
21. Meanwhile, we have been considering the underlying funding arrangements for the FSCS. In 2006 we decided to hold a review in order to rectify a number of problems that had been identified. One clear deficiency was the overall capacity of the scheme; in our judgement it was necessary to increase the range of events where we could ensure that consumers would be paid when valid compensation claims were made. Currently the amount available to the deposit taking sub-scheme is a perpetual limit of 0.3% of protected deposits – a total of around £2.6bn. Our proposals, on which we consulted earlier this year, will substantially increase the funding available to around £4bn per year across all sectors¹. While limited, this would significantly increase the funding available to the FSCS. We said in our Consultation Paper that we were not intending to establish a

¹ The existing scheme's funding is restricted to each contribution group: deposit-taking £2.6bn (0.3% of protected deposits in total over the lifetime of claims received); general insurance providers £267m annually (0.8% of relevant net premium income); general insurance intermediaries £82m annually (0.8% of annual eligible income); life and pensions providers £544m annually (0.8% of relevant net premium income); investment firms £400m annually; and mortgage intermediaries £14m annually (0.8% of annual eligible income). The amounts available would **not** be available to other groups as the current scheme does not allow for any cross-subsidy.

funding model capable of providing total cover in all instances, and we still believe this to be the correct approach. As we noted in our Consultation Paper, we would expect a large-scale failure to trigger the crisis management arrangements set out in the Tripartite Memorandum of Understanding.

22. Nearly all the industry strongly opposed our proposals, arguing that there was no need to change the current arrangements, which they believed were fit for purpose, and that introducing greater cross-subsidy between different classes of firms was inappropriate. We are currently finalising our formal policy on the future funding model. The new funding model, with its increased capacity, would be introduced from 1 April 2008.
23. Working with the Treasury, the Bank of England and the FSCS, we will build on work that we began in 2006, in order to consider the broader framework within which the FSCS operates. We will focus on how best to deliver an appropriate level of assurance to consumers, including looking at both the monetary limits and improving the speed with which compensation payments can be made to consumers in the event of a large default. In this context it will be important to find a solution for deposit protection which takes account of appropriate changes to compensation arrangements more broadly, including in other financial sectors, and to avoid unintended consequences and possible knock-on effects. As the Chancellor announced on 1 October, the Government intends to legislate to implement a more fundamental reform of the framework for depositor protection. We will consult jointly with Treasury as appropriate on further changes to the regime.

5 October 2007

The Treasury Committee

2nd Memorandum from the Financial Services Authority

Current regulatory issues

24. In this Memorandum we deal with other current regulatory issues under two main headings:

- Helping retail consumers achieve a fair deal; and
- Promoting efficient, orderly and fair markets.

A. Helping retail consumers achieve a fair deal

25. The challenges for the retail financial services market – on both the supply and demand side – are well recognised. On the demand side, our financial capability strategy has moved into the implementation phase and continues to make good progress, working with a wide range of partners in the financial services industry, central and local government, government agencies, the voluntary sector, employers and others. Our own revamped consumer website *Moneymadeclear*, including targeted campaigns on general insurance and retirement, is well received by increasing numbers of consumers.

26. On the supply side, our proactive approach to the regulation of financial promotions has led to an improvement in standards of promotions in the press. As we reported earlier this year, we have found encouraging progress in firms' implementation of their Treating Customers Fairly work, though it has tended to be weaker on the part of smaller firms. For those firms that failed to meet the deadline we have taken follow-up action. On 2 October we announced an enhanced small firms strategy to deliver more help and advice and a tougher approach to those who continue to fall short of required standards. We continue to identify a number of areas where consumer detriment remains significant – for example, sales of Payment Protection Insurance and advice on sub-prime mortgages. In such cases we are taking action, including enforcement proceedings, against firms which are falling seriously short. In our Retail Distribution Review we are working with the industry and consumers to address some deep-seated structural problems in the retail financial services market.

Treating Customers Fairly

27. Our Treating Customers Fairly (TCF) work is a key element in our regulation of the retail financial services market. Firms have made much progress, but there is more to do to improve the outcomes experienced by consumers.²

² The outcomes we are aiming to achieve are:

1. Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

28. We have said to all firms that by the end of 2008 we expect them to be able to demonstrate that they are consistently treating their customers fairly. Achieving this will require cultural change in many firms, and they will also need appropriate management information; as evidence of continuing progress we expect firms by the end of March 2008 to have management information in place to enable them to check whether they are treating their customers fairly.
29. In July we published Guidance on the responsibilities of product providers and distributors. We believe that consumers are entitled to the same standards of fairness whether one or more firms are involved in the supply of a product. The Guidance sets out the responsibilities of providers and distributors for treating customers fairly at the various stages of the product lifecycle.

Payment Protection Insurance (PPI)

30. Improving the sales standards of Payment Protection Insurance (PPI) continues to be a major priority for the FSA. We recently published findings from our latest PPI mystery shopping and firm visits. We found improvements in some areas, but many firms are still failing to treat their customers fairly when selling this product.
31. We had previously set out five areas where improvements in standards were required. Our latest work found improvements in only two of these, namely in making it clear that PPI is optional and providing refunds on virtually all single-premium policies. Little or no improvement was found in the remaining three, including the disclosure of price and policy details as well as firms' consideration of eligibility and suitability.
32. As a result of the latest work, and in addition to the past public disciplinary action against ten firms, four firms are now subject to further enforcement investigation, and a further 20 firms may also be investigated. Moreover, following FSA work:
 - eleven firms have stopped selling PPI either permanently or temporarily until they get their sales processes in order and/or retrain staff;
 - three firms have cancelled their authorisation to sell PPI; and
 - four large firms are reviewing past PPI sales to ensure they were appropriate.
33. In line with its general approach, we are seeking to increase the level of fines where this is warranted by the nature, seriousness and impact of the breach in question, and by the likely impact on deterrence. Firms have been given due warning of their obligations to treat their customers fairly, both generally and on PPI in particular. Consequently, the FSA will now seek to impose higher fines for firms in the PPI market where standards fall below required level.

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2. Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
 3. Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
 4. Where consumers receive advice, the advice is suitable and takes account of their circumstances.
 5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and also as they have been led to expect.
 6. Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

34. Given our findings, we will continue to work to improve sales processes and we intend to strengthen our action against those who fail to meet their obligations. Going forward, our programme of work will include: pursuing formal disciplinary action; further firm visits and mystery shopping; and focused work on issues that cut across the PPI market, for example, reviewing single-premium refund terms to ensure they are calculated fairly.
35. We are also working to improve consumers' understanding of PPI to strengthen their role in this market and help them to shop around. Earlier this year, we ran a campaign to encourage consumers to access and use insurance information, including about PPI, on our Moneymadeclear website. We continue to receive around 1,000 visits to our PPI web pages each month. In response to an earlier request from the Committee, we are developing online tables on PPI and will publish them in March 2008, enabling consumers to compare and shop around.
36. We continue to work closely with the Competition Commission to help inform its inquiry into the PPI market.

Financial promotions

37. In our letter to the Committee of 17 November 2006, we outlined our proactive approach to the supervision of financial promotions and the benefits being delivered for consumers. Since then, we have continued to consider complaints from firms and consumers to our Financial Promotions Hotline and have enhanced our proactive monitoring of a range of media. This has led to continued improvements in standards of financial promotions in the national press.
38. Over the last two years, we have focused on the mortgage sector (including, in particular, firms targeting the sub-prime market). We have:
 - told more than 300 mortgage brokers to withdraw or amend misleading advertising;
 - visited the worst offenders and taken action as a result; and
 - referred a number of firms for enforcement investigation. We fined one firm, Select Mortgage Services, in September 2007 in relation to their mortgage financial promotions and other serious failings, and other firms are currently subject to similar action.
39. Following informal discussions with industry and consumer stakeholders, we are also implementing extra measures to help firms raise standards, including:
 - targeted and timely anonymised case studies setting out our expectations;
 - regular, enhanced regulatory information on the issues which prompted us to request firms to withdraw or amend their advertising;
 - the outcomes of our targeted thematic work; and
 - aggregated statistics reporting on remedial action.

Unauthorised Overdraft Charges

40. On 27 July, the OFT and a number of UK banks initiated a test case in the High Court to resolve legal uncertainties on the level, fairness and lawfulness of unauthorised overdraft

charges. In order to facilitate the test case we granted a waiver of our complaints-handling rules as they apply to complaints about unauthorised overdraft charges.

41. We granted the waiver because we believed that it was not in the interests of all consumers for complaints to continue to be dealt with in an inconsistent way. Once there is legal certainty, firms will be able to deal with these complaints fairly and consistently. To protect consumers' interests while the test case proceeds, the waiver contains a number of conditions to which firms must adhere. The Banking Code requirement for banks to deal with persons in financial difficulty sympathetically and positively has not been affected by the waiver.
42. We acknowledge that our decision will lead to inconvenience and delay for some consumers – particularly those who were in the advanced stages of making a claim – in that their complaint may now not be resolved for some time. However, we are clear that the way in which complaints have been handled in the recent past is unsatisfactory and not in the broader public interest in the longer term.
43. As we committed to when we granted the waiver, we are now undertaking a review of its effectiveness to ensure, among other things, that firms are complying with its conditions. We have sought information from the banks and building societies which have taken up the waiver and will use this to inform our decision as to whether or not to revoke the waiver. As part of the review, we are also consulting consumer groups. We expect the review to be completed by the end of October. Going forward, we can revoke the waiver at any time if we consider that it is no longer appropriate because, for example, the test case is not progressing or if a delay in the resolution of the test case is likely to cause undue risk to consumers.
44. The first phase of the test case is expected to start on 14 January 2008. We will continue to work closely with the OFT and the FOS on this issue.

Our supervision of small retail firms

45. Over 90% of the firms we regulate are small (both retail and wholesale). There are 18,000 small retail firms which are mainly general insurance brokers, mortgage brokers and independent financial advisers. We recognise the challenge which regulation poses for them and us. We have recently carried out an analysis of levels of small firm compliance in the retail sector, using data and other information reported to us by firms as well as the results of our own thematic reviews. In the light of this and taking into account feedback from our Smaller Businesses Practitioner Panel, we have recently announced an enhancement of our supervision of this sector. We want to work more in partnership with those firms trying to run a compliant business and to treat their customers fairly, in order to raise standards. This further contact will also enable us to identify more quickly those firms who are not meeting regulatory standards, and be able to better target our resources on those firms more effectively. The new measures being introduced, which build on our current risk-based approach, will include a large-scale series of structured visits and/or telephone assessments. This will involve an increase in supervisory resources, which will in turn have a knock-on effect on fees for this population. We will provide further details in due course and any increases will be consulted on with firms in the normal manner next year, but we will ensure that our enhanced approach delivers good value help for firms.

We believe that these changes will help millions of consumers who are seeking advice on major financial decisions to be treated fairly by firms in this sector. Similarly, we are also increasing our contact with the smaller wholesale firms through visits and thematic reviews.

Sales of sub-prime mortgages in the UK

46. A major focus of our thematic work in the retail sector this year has been the sub-prime mortgage sector in the UK. In July we published our latest review of the behaviour of intermediaries and lenders in this market. As a result of the shortcomings we found, we have referred five firms to enforcement, including those whose failings were identified during the initial study of this market in 2005, and who failed to show adequate improvement. Our work on the mortgage sector in the coming months will focus on issues of affordability, responsible lending and the quality of advice-giving processes in firms. Within this, we will be paying particular attention to self-certification business, and, next year, Right to Buy.

Financial capability

47. We estimate that in the past year the financial capability programme which we lead has reached more than 1.7 million of the ten million people we aim to reach by 2011. In its report earlier this year the National Audit Office recently described us as 'a world leader in financial capability'. Our seven-point programme targets: school children; young adults who are Not in Education, Employment or Training (NEET); students in universities and further education colleges; employees in their workplace; and new parents. We also deliver straightforward information and advice to a wide audience through our *Moneymadeclear* consumer website and publications, and to groups of consumers of priority need through our Innovation Fund.
48. We plan to spend up to £90m on financial capability in the five years to 2010/11, and we are currently working on our strategy taking us beyond this point. We look forward to publication of the Treasury's financial capability action plan later this year, which we expect will complement our work in this area.

Generic Financial Advice

49. The provision of generic financial advice has always been a key component of our National Strategy for Financial Capability. We have, for example, worked with the Financial Services Skills Council to create National Occupational Standards for generic financial advice, which define the competencies required for providing such advice. Earlier this year we launched our *Moneymadeclear* website, and we have made good progress in building relationships with a range of trusted intermediaries (such as housing workers, youth workers and voluntary advisory services) to support the expansion of entry level generic financial advice.
50. It is clear, however, that these intermediaries cannot be expected to give more in-depth advice, for which specialist provision – and additional funding - is required. We welcome the Government's decision to invite Otto Thoresen to conduct a review into the provision of generic financial advice. We are working closely with him and his team and we look forward to his conclusions and recommendations. We believe it will be important to ensure that the new national approach complements, and is integrated with,

existing approaches, including both the National Strategy and organisations such as Citizens Advice who already provide face-to-face advice.

Information for consumers

51. Clear, simple and impartial information for consumers is crucial in helping them to make sound financial decisions. Our main direct channels of communication with consumers are our website, Moneymadeclear.fsa.gov.uk, our hard copy guides and our Consumer Contact Centre.
52. We re-launched our consumer information guides under the Moneymadeclear brand in June 2007. The new design emphasises the clarity, simplicity and impartiality of the information we provide on financial products and services – 'No selling. No jargon. Just the facts'. Our research has confirmed that consumers find the information highly valuable and the new design and layout much more appealing and engaging.
53. We are developing our distribution strategy to get our printed materials to the right people at the right time. We know from research that consumers expect the guides to be available on the High Street in bank or building society branches. A number of banks and building societies and two credit unions are working with us on a pilot over the next six months to stock a selection of our guides in their branches.
54. We have run two Moneymadeclear promotional advertising campaigns this year: *'Insurance made clear'* (Feb/Mar 2007); and *'Retiring soon'* (Sept/Oct 2007). Our evaluation shows that 85% of people surveyed found the site's content useful and informative, and 70% felt more likely to make an informed decision as a result of their visit. Tracking behaviour after the campaign confirms that consumers actually take action having had access to our material.

The Retail Distribution Review

55. In the light of widely shared concerns about the effectiveness of the market for distributing retail investment products, and wider developments in the market, last year we launched our Retail Distribution Review. In June this year we published, for consultation until the end of the year, our proposals developed in consultation with industry and consumer representatives. The proposals seek to: improve the current standards of professionalism; find more cost-effective ways of making advice available to a wider range of consumers; and improve consumer understanding of what they are getting for their money by trying to remove the inherent conflicts of interest that arise from commission-driven advice. The review applies to all parts of the distribution market, including banks, life companies and financial advisers.
56. The key proposal is that the regulated investment advice market could be divided into two parts, giving choices to firms and greater clarity to the consumer. These could be summarised as i) professional planning and advisory services, provided by highly qualified advisers and serving those consumers who need the full range of advice; and ii) primary advice, providing advice on more straightforward needs and using simple products.
57. We have taken no decisions on these issues. During the consultation period we are undertaking further research and analysis, considering in particular the impact on

smaller firms and how consumers might respond to the ideas put forward. We are keen to get the industry to find the best way to resolve the problems but we may need to make changes to our rules. Following consideration of feedback we receive and the results of our own work, we expect to publish any firm proposals for change in June 2008.

B Promoting efficient, orderly and fair markets

Private equity

58. We welcome the Committee's interim report on private equity, to which we have submitted a short response. The private equity sector remains a focus of our supervisory attention.
59. Meanwhile, we are continuing to work with overseas colleagues to achieve as proportionate and consistent an approach globally as possible to the regulation of private equity. Our work in the International Organisation of Securities Commissions (IOSCO) is an important component of this. Work is currently focusing on:
 - capital structures employed in leveraged buyout transactions; and
 - conflicts of interest which arise during the course of private equity business and the relevant controls utilised across relevant IOSCO member states which aim to provide appropriate levels of investor protection.

We are currently carrying out a thematic review to examine how the private equity sector manages its conflicts of interests.

Hedge funds

60. As the Committee is aware, in the light of the rapid growth in the hedge fund industry over the last year and the growing importance of hedge funds and private equity firms in the UK's financial sector, we have increased the number of staff supervising these sectors.
61. We assess the risks posed individually by the larger hedge fund managers and develop individual mitigation programmes consistent with our wider goal of efficient, orderly and fair markets. As a result of these mitigation programmes, fund managers have made improvements to their systems and controls, for example those controls designed to prevent conflicts of interest and market abuse. We have been extending our relationship management approach to more fund managers.
62. We have played a leading role in work with other regulators on the issues surrounding valuation of complex illiquid instruments and strongly support the work of IOSCO on valuation principles. Following the completion of thematic work late last year on valuations we have fed our views of good practice to hedge fund managers and the IOSCO valuations working group.
63. We have recently carried out thematic work on anti-market abuse systems and controls in hedge funds. Our overall conclusion is that the larger hedge funds seem to have reasonable systems and controls in place to handle price-sensitive information, though some funds have relatively limited systems for controlling the passage of inside information and personal dealing policies. We intend to publish an article setting out

good practice which hedge funds will be able to judge themselves against and decide what would be appropriate for their individual circumstances.

64. We continue to consider the question of retail access to hedge funds. We published our proposals earlier this year on "Funds of Alternative Investment Funds (FAIFs)", proposing that the authorised schemes regime should include funds of funds that themselves might invest all their assets in unregulated collective investment schemes. (At the moment, authorised schemes are restricted to investing only 20% of their assets in unregulated schemes.) Creating such a regime would bring the UK into line with other countries who already have such regimes, including France, Germany, Italy and Spain.
65. If we decide to proceed with our proposals, our intention is to make final rules at the end of the year, subject to an appropriate regime for taxation being introduced to support the regime.

Market cleanliness and our work on market abuse and insider dealing

66. Our work to combat market abuse continues to be one of the FSA's key priorities. Our focus is on serious cases, which have the biggest impact on market cleanliness, and on encouraging listed issuers' compliance with disclosure obligations. Our work programme includes a mixture of enforcement, other deterrent measures, strengthening firms' systems and controls and increasing firms' awareness of issues (i.e. education).
67. There are significant challenges to successful prosecutions of insider dealing including a number of very difficult evidential hurdles to overcome. Showing the passage of price sensitive information from one person to another is difficult and most cases are circumstantial. There are also many defences available to defendants. Notwithstanding the challenges, we believe the risk of being caught is a significant deterrent and we are considering what more we can do to increase the number of enforcement outcomes. Additionally, we have stepped up our efforts to foster a partnership with the industry to encourage them to engage and draw matters of concern to our attention. As we have said previously, we are discussing with the Government whether they would consider amending the Serious Organised Crime Act 2005 so as to give the FSA the power to offer immunity from prosecution in return for individuals agreeing to give evidence for the FSA as prosecutor.
68. We are looking to reduce the opportunities for insider dealing ahead of public takeover announcements by focussing on the strength of industry systems and controls to prevent information leakage. In July 2007, we published results from a major thematic review which concluded that more effort is needed by all parties involved to avoid complacency. Follow-up work includes supervisory work with FSA firms and a voluntary, industry-led, Statement of Good Practice.

International work

69. We continue to devote significant effort to working with colleagues in the Treasury, the European Commission, overseas regulators and a range of international fora to agree international standards and to discuss issues of interpretation and implementation. Following significant effort by the industry, regulators and others, the Markets in Financial Instruments Directive will be implemented in the UK on 1 November this year. For the coming period the next major challenge is the negotiation of the Solvency 2 Directive, designed to establish a revised set of EU-wide, risk-based solvency requirements for life and non-life insurers and reinsurers, at a solo and group level. We are committed at the highest level to this project as demonstrated by Hector Sants replacing John Tiner as the FSA's Member of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The Basel Committee began work in early 2007 to take stock of supervisory approaches to liquidity regulation, within the wider institutional and legal context. The aim is to understand the range of approaches currently in use and to determine the consequences of diverse approaches to liquidity for supervisors, firms and crisis management. The Basel project will now incorporate an assessment of lessons learned from recent events; a report to the Basel Committee is still expected by the end of the year.

Review of our policy on regulatory disclosure

70. The issue of how much regulators can and should disclose to markets, consumers and others about their work, either at the time or after the event, is the subject of active continuing debate, in the UK and overseas. As early as 1998 the FSA committed itself to carrying out its responsibilities in an open and transparent way, and we keep our practices under regular review. Some time ago, for example, we discussed with stakeholders whether we should introduce a public register identifying financial promotions which have been amended or withdrawn following FSA intervention. Having look at this specific issue, we decided that we need to look at our transparency strategy in the round to see what part increased disclosure could play in improving regulatory outcomes across all our regulatory activities – authorisation, supervision and enforcement. We will discuss these issues with the industry and others in the coming months and plan to issue a Discussion Paper in the first quarter of next year.
71. In our consideration one relevant factor is freedom of information legislation, which exposes regulators' views on these issues to increased public scrutiny. As has been reported in the media, we have recently appealed decisions by the Information Commissioner requiring us to disclose the names of particular firms which were in the past subject to FSA regulatory action. We are currently resisting this disclosure because of our concern about the possible impact on our ability to continue to use certain regulatory tools, for example mystery shopping, effectively.