FSA

Financial Services Authority

A new regulator for the new millennium

January 2000

Contents

Introduction

Later this year the FSA will become the single regulator for the UK's financial services industry, following the enactment of the Financial Services and Markets Bill. The Authority's powers and governance have been extensively debated in Parliament. But what will matter most to regulated firms and their customers is the way in which the FSA carries out the business of regulation from day to day, and year to year.

This paper follows a strategic review carried out for the Board of the Authority in the second half of 1999. In that review we examined the approaches adopted by different regulators in the UK and elsewhere and sought to analyse, and learn from, past failures.

Building on the conclusions of that work, we set out here the main lines of the regulatory approach which the FSA will follow in the future. The paper describes how we propose to take the statutory objectives and the principles of good regulation in the Bill, and to translate them into regulatory activities. It also outlines a new and transparent operating framework within which the Board will set priorities, and which will allow consumers and practitioners to influence the allocation of resources and the intensity of regulatory effort.

Over time the consequences of the approach outlined in this document will be significant. The aim is to shift to a regime which:

- is built on a clear statement of the realistic aims and the limits of regulation;

- recognises the proper responsibilities of consumers themselves and of firms' own management, and the impossibility and undesirability of removing all risk and failure from the financial system;

- is founded on a risk-based approach to the regulation of all financial business which integrates and simplifies the different approaches adopted by the current regulators – this will in time lead to a zero-based assessment of the level and allocation of resources across the full range of the FSA's activities;

- operates a transparent new framework for identifying and addressing, as part of the regular planning cycle, the most important issues facing firms, markets and consumers. Each year the FSA will set out publicly the areas identified for priority attention – what we will describe as our regulatory themes;

- uses the full range of tools available to the Authority under the new legislation[1], including consumer education;

- switches resources from reactive post-event action towards front-end intervention;

- creates incentives for firms to manage their own risks better and thereby reduce the burden of regulations.

The chapters which follow explain:

- *how the FSA interprets its statutory objectives and the additional obligations set out in the Bill* (Chapter 1);

- *how we will assess the risks to achieving our objectives and address these through our new operating framework* (Chapter 2);

- *the range of tools which we have available* (Chapter 3);

- *how we will begin to put this strategic review into practice* (Chapter 4).

This paper is not part of our formal consultation process, but we would welcome comments from regulated firms, consumer representatives and others. They should be addressed to David Kenmir at the FSA (email: newreg@fsa.gov.uk). In line with our policy, we will continue to consult publicly on major policy and operational issues.

1 The policy and interpretations here are based on the December 1999 version of the Bill and may have to be adjusted in the light of any changes made before Royal Assent.

1 Statutory objectives and the principles of good regulation

The statutory objectives

1 The FSA's overall purpose is described in the four statutory objectives in the new legislation:

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

The Bill applies these objectives and the principles of good regulation (see below) directly to specific FSA activities – making rules, preparing and issuing codes, giving advice and guidance and determining the general policy and principles by which we act. In addition they form a more general foundation for our public accountability.

Market confidence

2 Market confidence is fundamental to any successful financial system; only if it is maintained will participants and users be willing to trade in financial markets and use the services of financial institutions. Maintaining this confidence involves, in our view, preserving both actual stability in the financial system and the reasonable expectation that it will remain stable.

3 This is achieved through:

- preventing material damage to the soundness of the UK financial system caused by the conduct of, or collapse of, firms, markets or financial infrastructure; and

- explaining on what basis confidence in the UK financial system is justified; this includes stating explicitly what the regulator can and cannot achieve.

Market confidence does not imply zero failure

4 The FSA *will* aim to maintain a regime which 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 in turn requires careful evaluation of the probability of any collapse, and its likely impact on the financial system.

5 There is a clear risk that the very existence of a regulatory regime may lead people to expect a higher degree of protection than is achievable or desirable. Under the public awareness objective, the FSA will therefore seek to explain what it aims to achieve within the financial system, so that when failures do occur, damage to market confidence is kept to a minimum.

6 Maintaining market confidence therefore does not, in the view of the FSA, imply aiming to prevent all collapses, or lapses in conduct, in the financial system. Given the nature of financial markets, which are inherently volatile, achieving a 'zero failure' regime is impossible and would in any case

Market confidence is fundamental to the success of any financial system.

be undesirable. Any such regime would be excessively burdensome for regulated firms and would not accord with the statutory objectives and principles. It would be likely to damage the economy as a whole and would be uneconomic from a cost-benefit point of view; it would stifle innovation and competition; and it would be inconsistent with the respective responsibilities of firms' management and of consumers for their own actions. Considerable dangers would arise if consumers or market participants believed that no firm would ever be allowed to collapse; this would reduce the incentive for individuals or firms to take due care in assessing the risk attaching to their financial decisions.

7 The FSA will nonetheless seek ways of minimising the impact of failures on market confidence. We will co-operate with the Treasury and the Bank of England on financial stability issues, under the Memorandum of Understanding agreed in 1997. We will retain and improve the mechanisms currently in place to protect consumers when firms collapse or fail to meet expected standards of conduct. In particular, the Financial Services Compensation Scheme will be available when firms are unable to meet their liabilities, and the Financial Ombudsman Service will deal with complaints by consumers against regulated firms.

Public awareness

8 Many consumers do not understand the financial system, the products and services offered and how they relate to their financial needs. Such consumers may not secure suitable products at fair prices; they may misunderstand the terms on which products are offered or may not realise the pros and cons of different product offerings. The FSA will therefore pursue two main aims under this objective:

- to improve general financial literacy; and
- to improve the information and advice available to consumers.

9 General financial literacy will be improved through programmes to help individuals acquire the knowledge and skills they need to be better informed consumers of financial services. Under the second heading, the FSA will provide, or help others provide, generic information and advice to consumers (e.g. comparative information tables) and will encourage others to improve the availability and quality of their advice. We will develop the information and enquiry services which we already provide directly to consumers, including the statutory register of authorised firms and the Consumer Helpline.

10 The FSA will give priority to filling a number of existing gaps in public understanding of retail financial products, in particular on the part of vulnerable and inexperienced consumers. In addition, we will use public awareness as a means of achieving our consumer protection objective. Improving public awareness will also be addressed by promoting financial education as an integral part of the educational system.

Consumer protection

11 The FSA is also charged with "providing an appropriate degree of protection for consumers". The principal risks which consumers may face in their financial affairs are:

- *prudential risk*
  the risk that a firm collapses, for example because of weak or incompetent management or lack of capital;

- *bad faith risk*
  the risk from fraud, misrepresentation, deliberate mis-selling or failure to disclose relevant information on the part of firms selling or advising on financial products;

- *complexity/unsuitability risk*
  the risk that consumers contract for a financial product or service they do not understand or which is unsuitable for their needs and circumstances;

- *performance risk*
  the risk that investments do not deliver hoped-for returns.

12 The FSA has a role to play in identifying and reducing prudential risk, bad faith risk and some aspects of complexity/unsuitability risk. It is not the FSA's responsibility to protect consumers from performance risk, which is inherent in investment markets – providing the firm recommending the product has explained to the consumer the risks involved and has not made excessive and unrealistic claims. Under the public awareness objective, the FSA will aim to ensure that consumers have a better understanding of the risks and opportunities involved in investment markets.

13 The level of protection provided will depend on the sophistication of the consumer; professional counterparties need (and want) much less

protection than retail consumers. It will also reflect the needs that consumers have for advice and information, and the general principle that consumers should take responsibility for their decisions.

Financial crime

14 Confidence in the financial system and consumer protection will be seriously undermined if the financial system and individual institutions are abused for criminal purposes. The FSA is therefore charged with reducing the extent to which it is possible for those organisations it regulates to be used in connection with financial crime.

15 The three main types of financial crime which the FSA will play a significant role in seeking to prevent are:

- money laundering;
- fraud or dishonesty, including financial e–crime and fraudulent marketing of investments; and
- criminal market misconduct, including insider dealing. The Bill will give the FSA new powers in this area.

16 We will be doing more work across the whole financial sector to assess the effectiveness of firms' money-laundering controls and customer identification procedures.

17 There are many other forms of financial crime (e.g. credit card fraud) where we will play a secondary role. We will work with other organisations (e.g. the police, the Serious Fraud Office and the Department of Trade and Industry) to assist their efforts.

The FSA aims to ensure that consumers have a better understanding of the risks and opportunities in investment markets.

The principles of good regulation

18 In pursuing these objectives, the FSA will be required to take account of the additional obligations set out in the Bill. These provide guidance on the approach which Parliament expects the FSA to take. We set out the principles and our interpretation of them below.

- *Efficiency and economy*
  This principle relates to the way in which the FSA will allocate and deploy its resources.[2] When addressing a specific risk, the FSA will aim to select the options which are most efficient and economic. We will go beyond the statutory requirement to consult on fees and will consult also on our Budget, explaining how we plan to use the funds levied through regulated firms. The non-executive committee of the FSA Board will be required, among other things, to oversee the FSA's use of its resources and to report annually to the Treasury. The Treasury will be able to commission value-for-money reviews of the Authority's operations. These mechanisms provide important controls over our efficiency and economy.

- *Role of management*
  A firm's senior management is responsible for its activities and for ensuring that its business is conducted in compliance with regulatory requirements. This principle is designed to guard against unnecessary intrusion by the regulator into firms' business and requires us to hold senior management responsible for risk management and controls within firms. We have already set out our proposed approach to senior management responsibilities.[3]

- *Proportionality*
  The restrictions imposed on firms and markets should be in proportion to the expected benefits for consumers and the industry. In making judgements in this area, the FSA will take into account the costs incurred by firms and consumers. One of the main techniques which the FSA will use is analysis of the costs and benefits of proposed regulatory requirements. This proportional approach will manifest itself in particular in different regulatory requirements applied to wholesale and retail markets.

2 Appendix 1 sets the FSA's operating costs and fee levels in the wider context.

3 'Senior management arrangements, systems and controls'. Consultative Paper 35, December 1999.

- *Innovation*
  We should facilitate innovation, for example by avoiding unreasonable barriers to entry or restrictions on existing market participants launching new financial products and services.

- *International character of financial services and markets and the desirability of maintaining the competitive position of the UK*
  The FSA will consider the impact on UK markets and consumers of the economic, industry and regulatory situation overseas. The FSA must also take into account the international mobility of much financial business and must avoid damaging the competitive position of the UK – which works to the advantage of consumers as well as markets. This will involve co-operating with overseas regulators, both to agree international standards and to monitor global firms and markets effectively.

- *Competition*
  The FSA must avoid unnecessarily distorting or impeding competition. This includes avoiding unnecessary regulatory barriers to entry or business expansion. Competition and innovation considerations play a key role in our cost-benefit analysis work. Under the new legislation, both the Office of Fair Trading and the Competition Commission will have a role to play in reviewing the impact of the FSA's rules and practices on competition.

19 The key elements of the new approach to regulation which results from this analysis of the statutory objectives and principles of good regulation is summarised in the following paragraphs.

The FSA's new approach to regulation

20 The FSA's declared aim is to be a world-leading regulator, respected for its effectiveness, integrity and expertise both at home and abroad. We believe that if we achieve that aim we will contribute to the maintenance of London's competitive position and to our consumer protection duties.

21 Our goal is to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal. We will do this in a number of ways:

- **Getting a fair deal for consumers**
  Emphasising the importance of disclosure of information.
  Disclosure, by firms and others (including the FSA), can reduce the complexity risk faced by consumers and provides a means of maintaining fair, efficient and competitive markets. Transparency of information in the marketplace facilitates market discipline, which in turn maintains standards of conduct.

- **Improving industry performance**
  Creating incentives for firms themselves to maintain standards and seek continuous improvement in practices, so making it possible for the regulator to step back.

- **Flexible and proactive regulation**
  Focusing resources on the areas of greatest risk to our statutory objectives, drawing on effective intelligence-gathering – including consumer research, economic analysis and practitioner liaison – to identify the most important risks, and using our new operating framework to focus resources to address them.

  A bias towards proactivity, seeking to identify and reduce risks before they cause significant damage. This will include speaking out promptly and publicly on major issues, highlighting both good and bad practice among regulated firms and potential problems for consumers.

- **Maximising our effectiveness**
  Selecting from a full range of regulatory tools. The FSA will have an extensive range of regulatory tools and will select those which most effectively address the risks identified. Where appropriate, it will pilot new approaches and evaluate their success.

The FSA aims to be a world-leading regulator, respected for its effectiveness, integrity and expertise.

Focusing regulatory activities. The FSA will focus its work more on targeted inquiry into specific issues rather than on open-ended information-gathering and routine inspection.

Recruiting and retaining high-quality staff, providing them with the necessary skills, and building the FSA's reputation as an attractive and rewarding place to work.

Taking full advantage of technology to improve its efficiency, to analyse and understand markets better in order to obtain early warning of emerging risks, and to deliver generic information and advice to consumers. The FSA will harness technology to assist it in its aim of despatching its business (for example, approving individuals or communicating with consumers) promptly and efficiently.

Being influential on the world stage, helping to raise international standards, maintaining the position of the UK as a global financial centre and protecting consumers of UK-regulated firms.

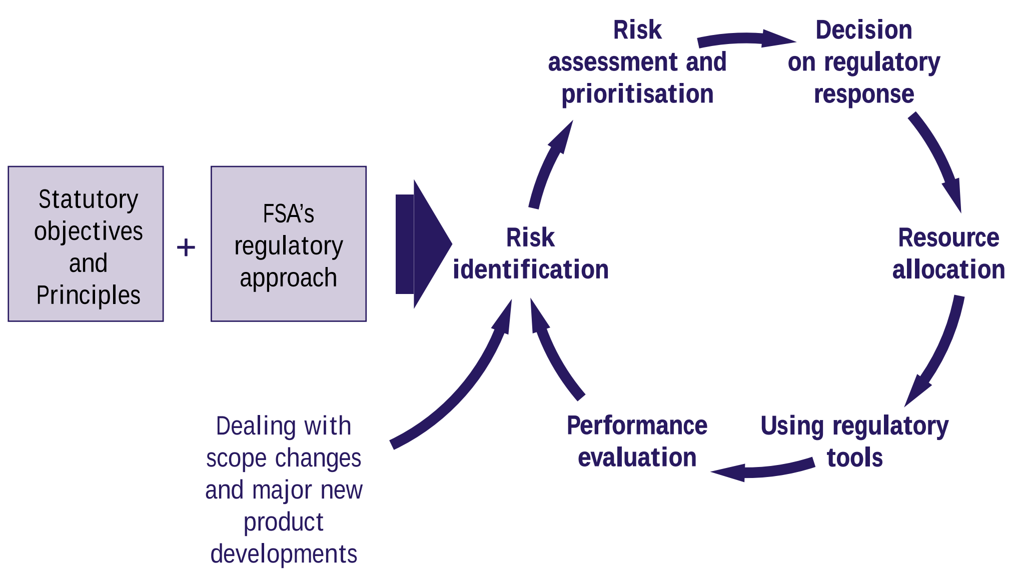
2 The FSA's new operating framework

Introduction

22 We have developed a new operating framework, designed to identify the main risks to our statutory objectives as they arise and to help plan how to address these risks in line with the new regulatory approach. The framework is thus the bridge linking the statutory objectives and our regulatory activities.

23 The framework is illustrated in Figure 1.

Figure 1 The FSA's new operating framework



Risk identification

24 The first stage in the process is to *identify the risks to the statutory objectives*. In doing this the FSA will draw on a wide range of sources, including intelligence gathered in the course of supervision of firms and direct contacts with consumers, and through economic and market monitoring. We will also conduct regular focused reviews of the industry and consumers, using tools such as market research, discussions with markets and exchanges, and mystery shopping. We will regularly consult a wide range of stakeholders, including market participants and the Consumer and Practitioner Panels, and will plan to draw on information supplied by the Ombudsman on industry trends and particular problems revealed through complaints.

Risk assessment and prioritisation

25 The next stage is to *assess and prioritise* the risks. The FSA will use a standard risk assessment process applied consistently across all its activities. This will in due course replace the existing risk assessment processes (RATE, FIBSPAM, etc). It involves scoring the risk against a number of *probability* and *impact* factors. The *probability* factors relate to the likelihood of the event happening, and the *impact* factors indicate the scale and significance of the problem if it were to occur. A combination of the probability and impact factors gives a measure of the overall risk posed to the FSA's objectives. This will be used to prioritise the risks, inform decisions on the regulatory response and, together with an assessment of the costs and benefits of using alternative regulatory tools, help determine resource allocation.

26 The impact factors will be similar for all types of risk, irrespective of the source, and include considerations such as the number of retail consumers affected and the systemic nature of the problem. For *firm-specific risks* there is a common set of probability factors grouped into three categories – control risk, business risk and consumer relationship risk. For *product-specific risks* or *macro-economic risks*, other probability factors will need to be identified. This is explained in more detail below. Although it is convenient to describe and analyse firm-specific and consumer and industry-wide risks separately, in practice assessment of all risks has to be co-ordinated, in order to gauge the overall threat to our objectives.

Assessing firm-specific risks: impact and probability factors

27 Figure 2 illustrates how this model would be applied to firm-specific risks. This is explained in greater detail in Box 1 opposite.

Figure 2 Risk assessment and prioritisation: firm-specific

Example factors
(for assessment)

- Systemic nature of firm
- Perceived importance of firm
- Impact on and number of retail customers
- Availability of compensation for consumer loss

- Control measures
- Business measures
- Consumer relationship measures

How impact and probability are measured and combined for firms

28 In addition to considering these impact and probability gradings, the FSA will take into account three further factors: the level of confidence in the information on which the risk assessment is based; (for overseas firms) the quality of the home regulatory regime – in particular, the extent to which it meets internationally agreed standards of best practice; and the anticipated direction of change in impact and probability gradings. These criteria are not formally included in the risk assessment, but they may affect the choice of supervisory approach and activities. For example, low confidence in the quality of the information or in the home regulator may make a closer supervisory relationship more appropriate.

Box 1

Assessing firm-specific risks: impact and probability factors

IMPACT FACTORS

For firm-specific risks, the first step is to assess the impact were a particular event to occur.

Impact relates to the damage that a regulatory problem within a firm (collapse or lapse of conduct) would cause to the FSA's objectives. While a firm may have a high probability of a regulatory problem, if it is low impact (e.g. a small firm conducting little retail business) the overall risk posed to the objectives is likely to be low.

The impact of an event will be assessed by reference to the following criteria:

- Systemic significance of the firm (that is, the impact which the collapse of the firm would have on the industry as a whole);
- Perceived importance of the firm (impact of the firm's collapse on public perception of the market and thereby on market confidence);
- Retail customer base (number and nature of customers, nature of customers' exposure to firm);
- Availability of compensation or redress for consumer loss.

In assessing impact, we will also take into account the cumulative effect of problems in a number of similar firms, even though, considered individually, the firms concerned might be graded low-impact.

PROBABILITY FACTORS

For firm-specific risks, the probability of a problem occurring is assessed under three headings:

1 *Business risk*

The risk arising from the underlying nature of the industry, the external context and the firm's business decisions and strategy. High business risk on its own may not pose a threat to the stability of a firm, if the controls are sound. However, the firm could collapse if its capital or controls are inadequate for the business risks it faces. Business risk relates to:

- Capital adequacy (ability to absorb volatility/loss);
- Volatility of balance sheet (risk of portfolio of assets and liabilities, exposure to external risks);
- Volatility and growth of earnings (historical trends and patterns, mix of business, sources of income);
- Strategy (change in business, sustainability of earnings).

2 *Control risk*

The risk that a firm cannot or will not assess, understand, and respond appropriately to the risks it faces. High control risk means that the firm's controls are not adequate in the light of its business risk. Control risk sub-divides into consideration of:

- Internal systems and controls (information flow, decision-making processes, risk management, etc);
- Board, management and staff (skill, competence, fitness and propriety, etc);
- Controls culture (adherence to internal controls, compliance record, etc).

3 *Consumer relationship risk*

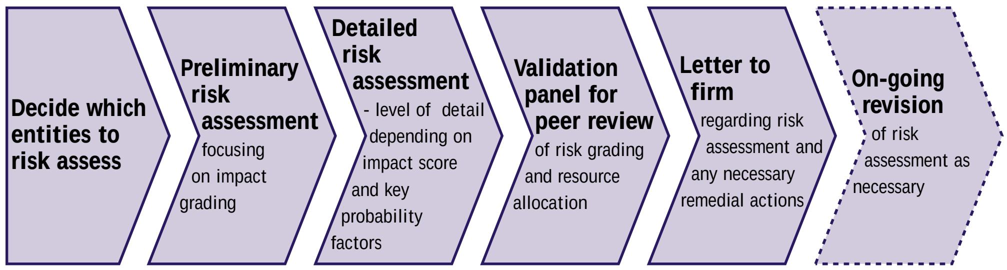
The risk that the firm will cause damage to consumers by failing to provide suitable products and services. In this respect firms operating exclusively in wholesale markets will typically be lower risk. A medium/high impact firm with a medium/high risk grading could constitute a threat to the consumer protection objective. A substantial problem of this nature could also affect market confidence. This risk is assessed by reference to:

- Nature of customers and products (focusing on any mismatch between customer sophistication and product sold);
- Marketing, selling and advice practices (focusing on sales force incentives, compliance culture, record-keeping).

Risk assessment process for firms

29 The risk assessment process will apply equally to all firms, although the detail required will vary from firm to firm. High impact firms are likely to require a more detailed assessment. Consistency will be ensured through a peer review process and internal audit. The main steps in the process are illustrated and described in Figure 3.

Figure 3 The risk assessment process



30 In order to create incentives for firms to raise standards and to maximise the success of the regulatory programme, it will be important that the firm understand the risk evaluation so that it can take appropriate remedial action. The FSA therefore envisages communicating to the firm the outcome of its risk assessment, the direction in which the assessment appears to be moving and the basis for the assessment. Further work is needed on the phasing and detail of this approach. We do not propose to make the assessments public.

31 This process of analysing impact and risk will result in a classification of firms and in variations in the intensity of the FSA's supervisory relationship with firms. Further details are given in Box 2 opposite.

Box 2

The nature and intensity of the FSA's supervisory relationship with firms

The nature and intensity of the FSA's relationship with a firm will depend on its assessment of the impact of the firm on consumers and on market participants.

At one end of the spectrum the FSA will expect to maintain a continuous relationship with certain firms, in order to develop and sustain a detailed understanding of current and potential areas of risk in the firm. This approach will be **resource-intensive** and will be efficient only for firms with a **high impact grading**. Supervisors of firms in this category will maintain regular working relationships with the firm's senior management team in order to understand the firm's systems and controls, and to be aware of other areas of potential risk through knowledge of the firm's business, structure, key processes and systems.

At the other end of the spectrum the FSA expects to cover large numbers of mainly small firms, which it assesses as **low-impact**, using a **remote monitoring** approach combined with visits, as necessary, in relation to specific issues. This relies heavily on carrying out a common set of activities across large numbers of firms, in order to investigate cross-industry risks, rather than focusing resource on individual firms. Firms in this category would not have a regular relationship with the FSA, but would be expected to submit periodic returns for automated analysis, and to inform the FSA of any major strategic developments. Their selling trends and practices would be monitored, and they would be included in industry-wide sampling exercises. They would also have a nominated contact point in the FSA. The FSA will consider how best to offer guidance – including via industry Helplines – to firms with which it will not have a regular supervisory relationship.

Where a firm within a particular supervisory category enters a situation of heightened risk, the intensity of the supervisory relationship will be adjusted accordingly, for a temporary period until the events prompting the crisis have been addressed. If the risks are not addressed within a set period, further action is likely to be appropriate (e.g. intervention, wind-down etc).

The FSA will explain to firms the nature of the supervisory relationship so that they understand what to expect of the FSA. FSA supervisory staff, in turn, will have clear objectives for their activities. We will aim for a shared understanding of what information is required, when and why, and in which situations pre-notification is required (e.g. mergers and other major strategic moves). For firms engaged in more than one type of regulated business, the FSA's activities will continue to be co-ordinated through a lead supervisor.

The intensity of the FSA's supervisory relationship with a firm will also be influenced by our assessment of the firm's risk management procedures and practice. Well-managed firms whose own assessment of risk is sophisticated and effective will require less supervisory attention than a firm conducting similar business whose controls are not of the same quality. This approach provides an incentive to senior management to manage their firm's risks effectively and so reduce in-house compliance costs.

Assessing consumer and industry-wide risks: impact and probability factors

32 Figure 4 illustrates how this model would be applied to consumer and industry-wide risks.

Figure 4 Risk assessment and prioritisation: Product-related industry-wide risk

Example factors
(for assessment)

- Number of retail customers affected
- Nature and size of potential loss
- Effect on consumers and on the industry as a whole
- Perceived importance of product or sector
- Availability of compensation

- Mismatch between complexity of product and target customers
- Typical charging structure for product
- Persistency rates
- Volume of customer complaints
- External comment

Impact factors

33 The impact factors for consumer and industry-wide risk will be similar to those used in assessing firm-specific risks. However, the probability factors for this sort of risk will be different.

34 In assessing the impact of a consumer and industry-wide risk the FSA will take into account:

- the systemic nature of the problem – that is, its effect on consumers and the industry as a whole;
- the perception of the importance of the product or industry sector to the financial market and consumers overall;
- the number of retail consumers involved and how they would be affected;
- the availability of compensation, either from the firms responsible for the loss or from the compensation scheme.

Probability factors

35 Assessing probability factors for consumer and industry-wide risks is, necessarily, a more diverse task and is likely to require exercise of judgement, as is the case in the framework for firm-specific risks. Factors that could indicate the probability of a retail problem such as the mis-selling of a product include:

- estimate of the mismatch between the complexity of the product being sold and the knowledge and sophistication of the consumers being targeted (this would be assessed through considering, among other things, the structure of the product, whether or not any options were built into the product and the volume of customer complaints);

- typical charging structure of the product (this may give an indication of how aggressively the product is being sold by salesforces);

- persistency rates for the product;

- volume of consumer complaints;

- external comment, for example from the industry, consumer groups and the media.

36 Different probability factors will need to be developed for assessing other consumer and industry-wide risks such as macro-economic risks (which could affect a firm's stability in a way that damages market confidence and possibly consumers) or risks associated with automated trading systems. Over time the FSA will build up a range of probability measures whose effectiveness can be monitored on an ongoing basis and reused as necessary.

Decision on regulatory response

37 Once the risks have been assessed and prioritised, the next stage is to decide on the response to the most important risks, bearing in mind the FSA's limited resources. The FSA will draw on the full range of its regulatory tools.

38 A number of possible responses to a given risk may be available. The FSA will use the principles of good regulation to help evaluate which is the most appropriate. Over time, performance evaluation will help build understanding of the most effective way to combine different regulatory

tools to address specific roles. Appendix 2 sets out our early thinking. Increasing emphasis will be given to consumer-oriented or industry-wide activities wherever possible; this will mark a significant shift away from current practice, which focuses mainly on firm-specific activities.

39 Over time, the FSA expects to shift the balance more towards thematic regulation and to carry out a number of focused theme projects each year. These will be agreed by the Board, will be published in the Plan and Budget and will be reported on subsequently. The portfolio of themes to be addressed in a given year will be selected to satisfy criteria such as:

- the risk should be one that needs to be addressed now;
- there should be some public output from the project, so that firms can take their own steps to deal with the risks in question (this approach is consistent with the responsibilities of firms' management, and with the FSA's bias towards proactivity);
- there must be clear benefit in addressing the particular risk on a pan-FSA basis, rather than within a particular division;
- the theme should be sufficiently important to justify the attention of senior management in regulated firms;
- the project should deliver measurable outcomes.

40 In the course of 2000 the FSA will carry out a number of pilot theme projects. Topics are likely to include:

- *E-commerce*
  The development of e-commerce carries wide implications for the FSA and is relevant to all four statutory objectives. There are both risks and opportunities for firms, consumers and regulators as the effects of globalisation and new delivery channels change market structure. The FSA will consider domestically and in international fora the implications of e-commerce for legitimate business and the enforcement challenges in respect of potential criminal activity.
- *The implications of a low-inflation environment*
  A low inflation environment brings clear benefits to the economy as a whole. However, both individuals and business in the UK have been accustomed to living in an environment of inflation. Improving consumer understanding of what a low-inflation environment means is therefore important. Lower nominal rates of return will have an impact

on some individuals and some firms. The project will identify ways in which the FSA's objectives can be met within such an environment.

- *Money laundering: customer identification and related requirements*
  Recent high-profile cases have underlined the importance of adequate controls against money laundering. This project will identify best practice appropriate to different circumstances, both at the stage of taking on a customer, and subsequently; it will have regard to different market sectors. The project will examine the contribution which the FSA should make, in co-operation with other relevant bodies, to the achievement of the regulatory objective for the reduction of financial crime.

- *Treating customers fairly after point of sale*
  In the past, regulatory attention has been focused largely on the initial purchase of an investment product and, in the case of deposit-takers and insurance companies, on the continuing viability of firms who have liabilities to depositors or policy-holders. The new legislation will require us to extend our attention to the treatment of customers after point of sale. The project will examine how the FSA can best address the new requirements and consumer expectations, drawing on the full range of regulatory tools available.

- *Harnessing market forces*
  This project will examine ways in which the FSA can harness market forces, as well as its own rules and requirements, to provide incentives for firms and their

The FSA expects to shift the balance more towards thematic regulation and to carry out a number of focused theme projects each year.

customers to behave in ways that will reduce the need for direct regulatory action. Going with the grain of the market and using incentive-based regulation is likely to be more efficient and cost-effective for both the FSA and for regulated firms.

Resource allocation

41 Resources will be allocated by the Board during the FSA's annual planning process. The timetable is driven by the need to consult in early February on the FSA's fees for the coming financial year beginning in April.

42 Planning starts with an annual review of performance against the FSA's overall objectives. This will compare what was actually achieved with the goals set at the outset of the period. The FSA can then build on this by discontinuing ineffective activities, implementing successfully piloted activities and comparing different methods for addressing similar risks to find the most economic and effective approach.

Dealing with changes in regulatory scope and major new product developments

43 A similar process can be adopted for deciding how to discharge any new functions given to the FSA (for example, the regulation of mortgages, or credit unions):

- the first step is to analyse the risk to the objectives presented by the new remit in order to prioritise it in relation to the existing risks already identified;
- the second stage involves developing options for addressing the risk using different combinations of the regulatory toolkit, before selecting the most appropriate combination;
- the FSA will then consult on its proposed approach and build it into its plan for that year.

3 The FSA's regulatory tools

Introduction

44 The FSA will have a wider range of objectives to meet than previous regulators and will therefore need to use a wider range of tools and responses. These can be divided into two categories:

- those designed to monitor and influence the behaviour of consumers at large, groups of regulated firms (or exchanges), or the financial services industry as a whole; and

- those designed to monitor and influence the behaviour of individual institutions (regulated firms, exchanges and clearing houses) and of approved individuals in firms.

45 The main elements of our regulatory toolkit are set out below. We expect, in the light of experience, to expand and refine the range of tools. At the end of this section we illustrate how the tools might be applied in two specific situations.

46 Applying this range of tools is likely to lead the FSA to deploy its resources significantly differently than regulators have in the past. It will be apparent that in future a greater proportion of the FSA's activities are likely to be directed to the industry or consumers in general, rather than to the supervision of individual institutions.

Activities directed towards consumers or the industry in general

47 This first group of regulatory tools is designed to influence the behaviour of consumers or of the industry in general.

Activities directed towards consumers in general

48 The principal tools for influencing consumers in general include:

- *Disclosure*
  Providing consumers with better and clearer information on products will help them to understand what they are buying and to make better decisions. Alternative disclosure regimes, including comparative information tables, will be market-tested to ensure that information is made available in forms that consumers can most readily understand.

- *Consumer education and public awareness building*
  Consumer education and public awareness building include both long-term projects (e.g. to improve the public's understanding of the financial system and their own financial needs) and initiatives specifically targeted at particular risks (e.g. increasing consumer understanding of the benefits and risks of particular types of product). Creating more knowledgeable consumers should reduce the need for firm-specific regulation, but it will take time.

- *Complaints-handling mechanisms and ombudsman service*
  These enable consumers to pursue complaints against firms and to secure redress where appropriate. They are a valuable source of intelligence for the FSA on market practices which may put the objectives at risk. They also contribute to consumer confidence.

- *The Compensation Scheme*
  This is an essential element in the regulatory system, in that it provides a safety net for consumers when a firm collapses. This in turn enables the FSA to adopt a proportionate approach to regulation and mitigates the impact of collapses when they occur.

- *Public statements*
  Public statements by the FSA (for example, on day trading or internet fraud) can alert the public and market participants at large to specific risks, and so influence the behaviour of consumers and firms. They are likely to be most effective in circumstances where dealing with

individual consumers or firms is not efficient or where other FSA action, such as changing disclosure rules or publishing the results of disciplinary action, involves too great a time lag.

- *Product approval*
  Product approval is a tool currently required (by EC law) for collective investment schemes (e.g. unit trusts) which are to be marketed to the public. This is designed to ensure that, unless shares are issued through a prospectus or a limited offering to professional investors, they may be offered to the public only through the authorised unit trust route.

The FSA will have a wider range of objectives … and will therefore need… a wider range of tools.

Activities directed towards the industry as a whole

49 The principal tools for influencing the industry as a whole include:

- *A training and competence regime*
  This regime is designed to raise standards and improve compliance in the industry. This brings clear benefits for consumers and reduces the need for firm-specific regulatory activities. In developing this regime, we will take into account our duty to avoid unnecessarily distorting or impeding competition and to facilitate innovation.

- *Rule making*
  Rules will set regulatory standards for the industry. Rule making is a necessary element in the FSA's regulatory toolkit, giving its standards statutory force. However, rules give rise to compliance costs for firms and monitoring costs for the FSA, which need to be weighed against the benefits. Excessive rules can

create an overly restrictive and bureaucratic system. We will ensure that clear guidance on interpretation of our rules is available to the industry and consumers.

- *Market monitoring*
  Economic developments at home and abroad can indicate threats to particular markets, firms, categories of consumer or products.
  The study of events in individual markets or products (for example through examination of price or transaction data or by monitoring the level of complaints about firms or products) can do likewise. The FSA will focus its monitoring on the areas – geographical, industry or product – most likely to provide information relevant to the risks to our objectives that we have identified.

- *Sector-wide projects*
  Some risks arise not in an individual firm but in particular market sectors. These are often best dealt with through a thematic project which co-ordinates a range of regulatory activities designed to investigate, understand and address the risk. Sector-wide projects will include such activities as desk-based reviews, firm visits, and other contact with firms. The FSA has already conducted a number of such projects, including the pensions review and the Y2K work.

- *International activities*
  Playing an active role in international working groups, and in dealing with individual overseas regulators brings the following benefits:
  - *Information sharing*
    The FSA must remain abreast of risks emerging in other markets which may affect the UK market and must inform other regulators about risks emerging in the UK;
  - *Understanding specific firms, regulators and markets*
    Good communication with the home regulators of international firms supports the regulation of those firms in the UK, first, by identifying concerns either expressed by, or due to the performance of, the home regulator and, second, by developing an understanding of market conditions in the firm's home country;
  - *Promoting best practice*
    Discussions with other regulators enables the FSA to learn from regulatory experience elsewhere and to promote best practice by influencing international policy development.

Activities directed towards individual institutions

50 The second group of regulatory tools is designed to influence the behaviour of individual institutions – firms, exchanges and clearing houses – and of approved individuals. They include:

- *Authorisation of firms and approval of individuals*
  Vetting at entry aims to allow only firms and individuals who satisfy the necessary criteria (including honesty, competence, and financial soundness) to engage in regulated activity. Experience in the UK and elsewhere shows that regulatory objectives are more likely to be achieved by setting and enforcing standards for entry, rather than having to deal with major problems later.

- *Perimeter injunctions and prosecutions*
  The FSA has the power to apply to the court for an injunction to stop unauthorised activity, and in some instances to prosecute those undertaking the activity. Where the activity has resulted in profits accruing to the unauthorised business or has caused losses or other adverse effects for consumers, the FSA may apply to the court for an order for restitution.

- *Supervision of firms, including desk-based reviews and on-site visits*
  Supervision of individual firms allows the FSA to monitor, identify and deal with firm-specific risks, and provides an insight into industry developments. This may, for example, involve changing capital requirements in response to a changing risk profile, or the instigation of focused reviews of particular business or control areas, whether by supervisors themselves or by reporting accountants working to a brief agreed by the FSA.

  In future, firms are in general likely to observe some rebalancing of supervisory activities, with a net reduction in overall routine supervisory activity. We envisage a significant increase in the level of thematic regulation, dealing with identified risks across categories of firms through targeted supervisory effort.

  In supervising financial services groups, we aim to create an integrated approach to regulation. A start has been made with the enhanced 'Lead Supervision' arrangements which are already making it easier to co-ordinate supervision of groups with multiple authorisations. 'Group Supervision' is a further initiative aimed at testing, on an experimental basis, whether any additional benefit might be gained by bringing into single teams all the resources needed to supervise complex financial groups.

- *Investigation*
  This is a tool used, where necessary, to develop a more detailed understanding of risks or problems identified in particular firms.

- **Intervention**
  Formal intervention powers are a tool to be used in cases where the risks are immediate and continuing and where the FSA believes that the firm will not take appropriate remedial action on its own.

- *Discipline*
  The FSA has available a variety of formal disciplinary powers enabling it to respond in a differentiated and targeted way to events, depending on the risks posed to the statutory objectives. Formal disciplinary tools are, as now, likely to apply to a minority of firms. These include:
  - *private warning* of firm or individual approved person;
  - *public censure* (public naming of firm or individual without imposing a financial penalty);
  - *financial penalties* (including public naming of firm or individual).

  Other formal disciplinary responses, such as withdrawal or suspension of authorisation, are also available. The FSA has already set out its approach to using its disciplinary powers. Further details will follow in the draft Enforcement Manual, to be published for consultation in April.

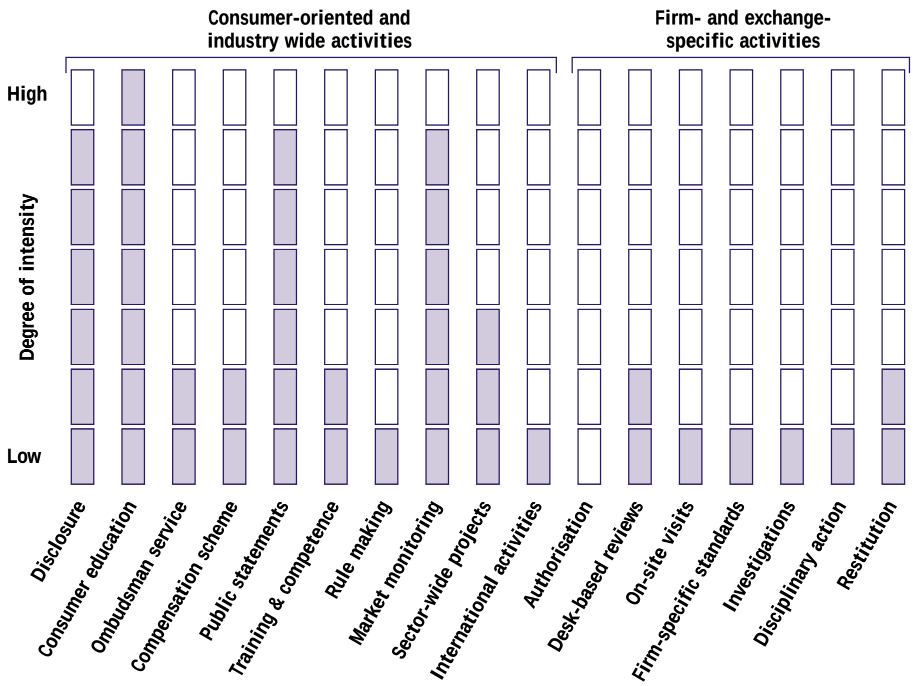
- *Restitution of loss*
  Where the failure of a regulated business to comply with regulatory requirements has resulted in profits accruing to the business or losses or other adverse effects for consumers, the FSA has power to apply to the court for an order for restitution. In addition, the FSA will have an administrative power, where a regulated firm has breached a regulatory requirement, to require it to compensate consumers for any consequent losses.

51 The explanation of institution-specific regulatory tools above focuses on regulated firms. In the case of recognised exchanges and clearing houses, special considerations apply. In particular, they operate under a different legal framework, within which the FSA has specific powers arising from its obligation to supervise their compliance with the statutory recognition criteria. Within this framework the FSA will develop and apply tools broadly similar to those used in relation to authorised firms.

How the range of regulatory tools would be used in practice

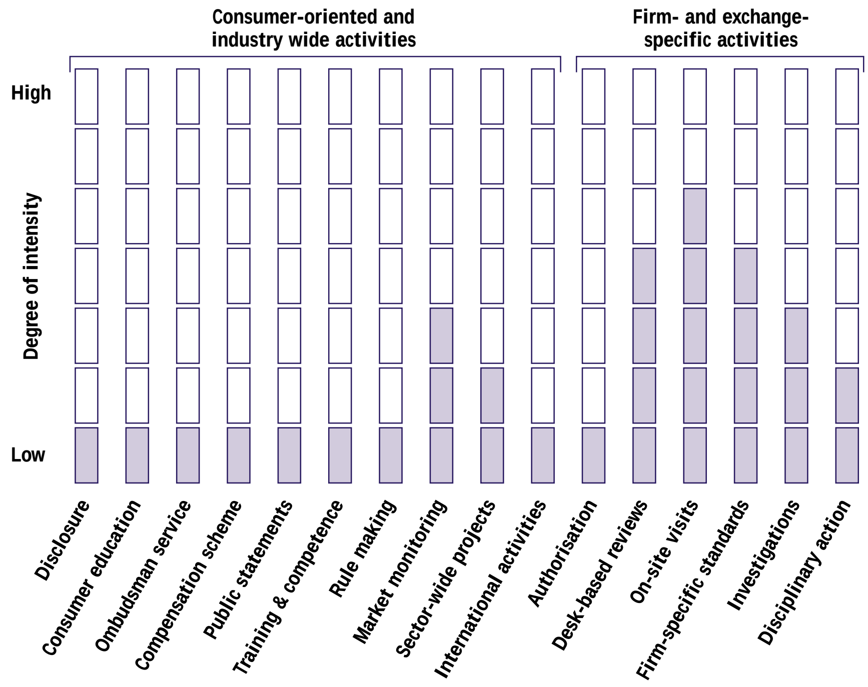
52 Figures 5 and 6 illustrate how the FSA might use this range of tools in response to particular situations. Figure 5 shows the ways in which the FSA might expect to act where risks have arisen as a result of a new product being marketed direct to the public. This approach might be appropriate, for example, in the early stages of the introduction of stakeholder pensions. The figure illustrates how in this case the emphasis is on consumer-oriented and industry-wide activities (e.g. consumer education, disclosure and market monitoring) rather than on firm-specific activities.

Figure 5 Response to risks arising from a new product being marketed direct to the public



53 Figure 6 shows how the FSA might use a different range of tools in response to a particular problem within a specific firm or group. It takes as an example a major bank with a significant capital markets operation, which includes trading for its own account in derivative products.
As a result of identified control and management weaknesses, the bank is vulnerable to major trading losses through errors, mismarking etc.
The example shows how the FSA's response in such situations is likely to

Figure 6 Choice of regulatory response: "firm-specific" approach



focus on the tools which are directed at individual firms, rather than those which are directed at consumers, at all banks, or at all firms engaged in proprietary trading.

54 The tools listed at the bottom of Figures 5 and 6 are illustrative only and do not represent the full range available to the FSA. For example, in the situation described in Figure 6, the FSA might well wish to commission work from the firm's external auditors, in addition to using the tools illustrated. Moreover, in both examples some of the tools are described in fairly high-level terms, whereas in practice careful consideration would need to be given, for example, to whether disciplinary action might be appropriate or precisely which issues are to be addressed in the course of a visit to a firm.

4 Implementation

55 The task of implementing the new approach described here – in particular, developing a single risk-based approach for use across all the sectors, markets and firms which the FSA will regulate – is substantial. We have set up an implementation team to drive these changes forward. That team will:

- develop the risk model and apply it, with appropriate modification, across the whole of the FSA's regulated community;
- oversee the allocation of authorised firms to different risk categories;
- articulate the details of the supervisory relationship needed in each category; and
- carry out a number of pilot theme projects as described in Chapter 3.

56 The new planning process described cannot operate fully for the 2000/01 financial year, as the new risk identification and assessment processes and regulatory toolkit require further development. Our target is that by the end of March 2001 we will be able to use our new risk assessment approach in relation to those we regulate.

57 In the planning cycle for the year 2001/02, we aim to implement in full the new operating framework, determining our strategic priorities and detailed plans in the light of a full assessment of the risks to our statutory objectives in the coming year. Throughout this process we will keep our stakeholders informed of progress.

Appendix 1

The costs of regulation in the UK and overseas: some facts and figures

The FSA's costs, in the wider context

The FSA's budgeted operating costs 1999/2000 (control total)	£ 159 m
The financial sector's share of UK GDP (estimate for fiscal year 1999/2000)	£ 50 bn

One of the few currently available sources comparing the costs of regulatory infrastructure and compliance internationally is the report of the Wallis Commission in Australia. That report quotes data (based on a range of very broad brush assumptions) from 'The Cost of Complying with Financial Services Regulation', August 1996, National Mutual and the Boston Consulting Group, as follows:

Cost of regulatory infrastructure
(expressed in relation to regulated financial assets, in units of 1/100th of a basis point*, 1994/95)

Australia	79
US	99
Canada	98
NZ	91
France	69
HK	51
UK	40

Compliance costs by country per annum†
(expressed in relation to regulated financial assets, in units of 1/100th of a basis point*, 1996)

US	1047
Australia	757
France	412
Canada	383
UK	275
NZ	136

* *One basis point = 1/100th of 1%.*

† *In future Annual Reports, starting in 2000, the FSA will publish an assessment of the regulatory burden and compliance costs of UK markets compared with overseas jurisdictions. We are working with other regulators to provide material which will allow us to do this.*

APPENDIX 2

Performance evaluation

The FSA's approach

1 The FSA's performance evaluation will be designed to assess whether:

- its activities, in aggregate, have been effective in achieving its statutory objectives; and
- its activities, in aggregate, comply with the principles of good regulation.

2 Illustrative indicators for each of the objectives and the principles are given below; this represents the FSA's early thinking and will be developed further in the course of the implementation project. Because of the inter-relationship between the objectives, many of the indicators below apply to more than one objective. The FSA will also set success criteria for individual projects and evaluate performance, in order to learn lessons for the future.

3 Assessing the achievement of the FSA's objectives and the impact of its regulatory activities is a complex exercise. We will develop "clusters" of performance indicators which, taken together, will give an overall picture. Some of these indicators will need careful interpretation. For example, an increase in the level of complaints by consumers may be a negative long-term indicator in relation to the consumer protection objective, but a short-term increase may be positive if it results from a consumer awareness programme designed to inform consumers of their rights or from more comprehensive complaints-recording by firms.

4 The FSA's aim will be to assess the outcome of an action rather than the input. Although outcome measures are more difficult to develop, they are more informative and will help users understand better the impact of the

FSA's actions. We expect that most performance measures will in due course have some form of target attached.

5 The FSA will aim to use third-party information where available in measuring its performance, both to reduce the cost and to provide an independent view. For example, international surveys such as that produced by the World Economic Forum contain a number of measures that provide useful indications of the UK's position relative to other financial markets (e.g. comparative measures for the ease of entry of new institutions into the banking market).

Examples of indicators to assess achievement of the objectives

6 We set out below our current thinking on possible measures to assess our achievement of the objectives.

Market confidence

7 An overall picture of market confidence can be built up through considering some of the following:

- *survey data* on the confidence of the public and regulated firms in the financial markets;
- *net inflows into personal savings products over time*;
- *volume of transactions on markets and exchanges*;
- *London's share in internationally traded products where regulation is a factor*;
- *bond spreads for financial institutions relative to other sectors,* to give an impartial view on how investors perceive the stability of financial firms;
- *number and nature of firm failures and failures in conduct,* taking into account the 'non-zero failure' policy outlined in Chapter 1.

Public awareness

8 Performance measures for public awareness could include:

- *survey data* on retail consumers' understanding of the products they have bought or their understanding of their financial needs and of financial services in general (the surveys could address questions such as: Is the FSA providing the information that people actually need? Are the FSA's efforts reaching the target audience in each case? How is consumer behaviour changing over time as a result of the FSA's initiatives?);

- *take-up of the FSA's booklets and use of the FSA's Helplines.*

Consumer protection

9 An aggregate picture of the FSA's performance in meeting its consumer protection objective could be built up by considering:

- *survey data* on retail consumer attitudes, including whether they thought they had adequate information and understanding to assess the products they were buying;

- *incidences of mis-selling* – both the trend in the number of cases uncovered and the absence of material mis-selling scandals would be important indicators in this area;

- *level of losses suffered by retail consumers*, both compensated and uncompensated;

- *volume, nature and outcome of complaints and ombudsman cases* will give a measure of the level of service consumers are receiving from firms;

- *volume of intervention or disciplinary actions* – again, this trend would need careful interpretation as an increase could mean either that firms were breaching the rules more often or that the FSA had improved its detection rate.

Financial crime

10 To assess the FSA's achievement of this objective, it would be relevant to consider:

- *incidences of money laundering*;
- *referrals to the National Criminal Intelligence Service*.

Examples of indicators of the FSA's compliance with the principles of good regulation

11 In addition to evaluating the FSA's aggregate performance in meeting its objectives, the FSA will also develop indicators relating to its compliance with the principles. Example indicators here could include:

- *Efficiency and economy* – These could also be assessed in aggregate by comparing the total regulatory costs in the UK with the costs imposed by overseas regulators and by looking at trends in the FSA's costs, as adjusted for changes in levels of activity in the industry and changes in the FSA's regulatory scope.
- *Proportionality* – The FSA has already published its approach to analysing the costs and benefits of proposed regulatory requirements. The output from this work will contribute substantially to the FSA's assessment of its compliance with this principle.
- *Innovation* – Indicators include the number of new product introductions in a given period in a particular sector or the number of innovatory start-ups.
- *International character of financial services* – Indicators include the trend in the absolute number of overseas firms doing business in the UK and the percentage of trading volume transacted in the UK for key exchange contracts or products.
- *Competition* – Indicators include the number of new authorisations in a given period, the trend in the price of key products and services, data on the concentration in providers for key markets and surveys on firms' perceptions of the market's openness to competition.

APPENDIX 3

How the FSA will assess success and failure in its regulation of firms and markets

Introduction

1 Regulatory success for the FSA will be delivered by achieving its statutory objectives and by taking into account the principles of good regulation. That will require a comprehensive evaluation framework, including indicators of progress in enhancing consumer understanding of financial products as well as more conventional measures of efficiency in regulatory processes. As part of our public accountability, our Annual Report will incorporate such a framework; some preliminary ideas are set out in Appendix 2 above.

2 One component of the framework will clearly be the incidence of failure (whether financial or regulatory) in firms and markets. Since, as noted earlier, the FSA will not aim for a "zero failure" regime, how should this aspect of the FSA's regulatory performance be assessed?

Criteria for assessing success and failure

3 In our view, a judgement on whether the FSA has succeeded or failed in achieving its objectives is likely to turn on five criteria:

- the extent to which the FSA has taken effective action to avoid risks to consumers by identifying and adressing issues pro-actively;
- whether, in the event of a collapse of, or lapse in conduct by, a firm, the FSA 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;

- the FSA's response to the event, in terms of prompt and effective remedial action; and

- the overall adequacy of its regulatory arrangements.

These are explained in more detail below.

4 Developing these criteria enables the FSA to identify the key risks to the achievement of its objectives, and to target its activities and resources accordingly. Publicising the criteria at the outset clarifies what the FSA believes regulation can and cannot achieve, and warns consumers that there are risks from which the FSA cannot (and should not) protect them.

5 In our view, the FSA would fail to meet its objectives in a particular case if it had failed to meet the standards which it has set out in relation to these criteria. For example, an isolated problem in a firm would not constitute failure if, once the problem came to light, the FSA – and the firm – took prompt and effective remedial action. On the other hand, if the FSA was unaware of a significant problem in a firm or market in a category which it had said it was monitoring on a regular basis, and it did not take adequate remedial action after the event, this would be a failure to meet the objectives.

The FSA's prior knowledge of the circumstances leading to the event

6 The key here is whether or not the FSA should reasonably have known that an event was likely to happen. For example, did regulators miss any significant indicators that would have alerted them to the problems, either during a periodic review of the firm's business, or in the course of routine market monitoring? Alternatively, did the FSA fail to follow its own regulatory process by, for example, not reviewing a firm even though its own risk assessment process specified that a review was due?

The impact of the event

7 The impact of the event on consumers and on the market and the rest of the industry is a important factor in determining whether or not the FSA has met its statutory objectives. Two aspects are relevant here:

- *The number and type of retail consumers affected*
  Retail consumers need greater protection than professional market users and participants. The FSA must balance this with a recognition

that the impact of an event on retail consumers is likely to be mitigated by the existence of the Compensation Scheme or other sources of compensation.

- *Systemic nature of the event*
  The questions here are: first, whether the event was one-off in nature or symptomatic of more widespread problems within a firm or industry sector; and, second, whether there are knock-on effects for other firms or parts of the industry. The FSA will be more concerned with (and will do more to prevent) events that are likely to have significant systemic consequences.

The FSA's response to the event

8 An important consideration is whether or not proportionate action was available to the FSA (either before or after the event) to deal with the problem. In most cases this will be so, and the question will be whether the FSA took that action with appropriate speed, decisiveness and boldness. Actions could involve, for example, intervention to limit losses and prevent further breaches, or warning consumers in good time about steps which they should themselves take; the FSA is not restricted to acting through regulated firms. There will also be cases where the FSA will rule out action on grounds of proportionality.

The overall adequacy of the FSA's regulatory arrangements

9 The final criterion relates to the overall adequacy of the FSA's arrangements, both in general and as they address specific risks. An isolated event may not represent a significant risk to the FSA's objectives; however, if it is one of a series of similar problems, it may suggest that the FSA's regulatory arrangements are not adequately focused on such risks.

Applying these criteria to practical examples

10 Appendix 4 presents a number of simplified case studies to illustrate how this approach would be applied in practice. In each example we say whether we believe the outcome should be regarded as success or failure in relation to achieving our objectives. We would be particularly interested in comments from consumers and practitioners on these case studies and the criteria outlined above.

Appendix 4

Case studies illustrating regulatory success and failure

These case studies are theoretical and for illustrative purposes only. They are designed to show how the FSA would assess whether in the circumstances it had achieved its statutory objectives. The examples given do not refer to any disciplinary action which it might be appropriate for the FSA to take after the event in such cases.

Did we meet our objectives?

Case 1: Regional stockbroker	Yes	No
• Regional stockbroker with 500 customers collapses due to unpaid debts on one client account; all client accounts pooled on collapse • Firm capital is insufficient to cover the deficit in client money • The FSA had not visited the firm for 4 years, having not yet conducted a periodic review that was due last year • Limited publicity; some concern expressed about other regional firms • Clients receive all stock holdings back after a short period; all cash claims paid out following £50,000 claim on the Compensation Scheme		• *breakdown of regulatory process* • *the FSA should have reviewed the firm the previous year;* • *would not have been failure had the FSA completed periodic review so long as no leading indicators had been missed*

Case 2: Small building society	Yes	No
• Small building society with £3m of deposits goes bust due to fraud on part of CEO • The FSA gave society clean bill of health at last periodic review 2 years ago. Once problem is discovered the FSA helps manage wind down • Some publicity, especially in local papers • Small retail consumers receive 100% payout from new compensation scheme • A small number of local companies lose a proportion of their deposits	• *no leading indicators missed* • *fraudulent action limited to one individual* • *no retail consumer loss after compensation payouts*	

Did we meet our objectives?

Case 3: UK insurance company	Yes	No
• Medium sized non-life insurance company with 100,000 policyholders, quoting aggressive premiums in order to win business through broker channels • The FSA aware that firm might have problems but allows it to carry on writing business - firm has dipped below minimum solvency requirements in the past but has provided additional capital when requested • Goes into provisional liquidation due to large unpaid broker debt • Limited press coverage • Policyholders had to find new cover but received 90% of unexpired premiums and between 90% and 100% of outstanding claims from policyholders protection board		• *the FSA did not pick up on warning signal (aggressive premiums) and* • *failed to take appropriate action*

Case 4: Wholesale investment company	Yes	No
• Large regulated proprietary investment company goes bust due to large trading losses • The FSA aware that company had large exposures but controls and risk management systems were good • Significant publicity • Portfolio liquidated resulting in major losses for a number of banks who had lend money • No retail consumer loss	• *no retail consumer loss and* • *the FSA aware of the exposures, which were not systemic for the market*	

Did we meet our objectives?

Case 5: Major UK bank	Yes	No
• Major UK bank loses £150m on trading desks • Had been considered low risk by the FSA with good prior record of compliance and controls • Subsequent audit shows trader had been given inappropriate limits given his experience and was poorly managed • Significant publicity with national news coverage • No retail consumer loss	• *isolated incident with no prior evidence of control problems at the firm;* • *no retail consumer loss*	

Case 6: High yield bond funds	Yes	No
• High yield bond funds offering 8% plus yields marketed aggressively by product providers • The FSA becomes concerned and provides guidance to firms to get them to explain better the risk/return trade-off to consumers • Take-up of funds continues to be high, especially in end-of-year ISA frenzy • Some time later credit spreads widen dramatically; many funds fail to return investors' original investment • Significant press publicity, with talk of "the second mis-selling scandal" and hardship stories of people claiming they "thought it was like a bank account" • No action taken by the FSA against firms on basis that customers should have known what they were buying		• *the FSA's response on becoming aware of problem was too timid;* • *would not have been a failure had the FSA taken bolder action by, for example, placing full page advertisements in newspapers alerting consumers to the risks*

Did we meet our objectives?

Case 7: IFA mis-selling	Yes	No
• Regional chain of IFAs investigated by the FSA for mis-selling following a routine visit • IFA had been visited 2 years previously and given clean bill of health • Investigation finds systematic "non-best advice" selling in addition to poor record keeping • 2,000 problem cases stretching over 5 year period • The FSA stops IFA selling and insists firm conducts full case review • All customers compensated by IFA which pays out a total of £100,000		• *mis-selling problem was material (widespread problem affecting 2,000 cases) and had been missed at the previous review*

Case 8: Non-regulated product	Yes	No
• Off-shore Internet company offers "limited opportunity to double your money in a year" on non-regulated investment • 1,000 UK investors subscribe a minimum of £5,000 each • The FSA unaware of situation until story breaks in press, but had previously published investment guides warning people of products offering excessive investment returns • Investors lose all their investment and get no compensation	• *the FSA had previously alerted consumers to the risks of schemes offering excessive investment returns*	

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (020)7676 1000 Fax: +44 (020)7676 1099
Website: http://www.fsa.gov.uk