National Audit Office

THE FINANCIAL SERVICES AUTHORITY

A REVIEW UNDER SECTION 12 OF THE FINANCIAL SERVICES AND MARKETS ACT 2000

April 2007

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National Audit Office

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THE FINANCIAL SERVICES AUTHORITY
A review under section 12 of the Financial Services and Markets Act 2000

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EXECUTIVE SUMMARY

1 London is one of the world's leading financial centres and financial services are a major source of wealth creation for the UK economy.[1] The Financial Services Authority (FSA) is one of the world's first 'unified' financial services regulators, formed by the merger of several earlier regulatory bodies between 1997 and 2000 and governed by the Financial Services and Markets Act 2000 (FSMA). It costs some £270 million a year to run and employs around 2,800 staff. The FSA authorises and regulates nearly 30,000 firms which carry out a range of financial activities[2].

2 The FSA's statutory objectives are to:

- maintain confidence in the financial system;
- promote public understanding of the financial system;
- secure the appropriate degree of protection for consumers; and
- reduce the extent to which regulated businesses can be used for financial crime.[3]

3 The task of the FSA is to provide scope for the development and discharge of legitimate financial business within a framework of systematic oversight that engenders trust in and compliance with the law among market participants and consumers. It has set out 11 Principles for Business which summarise the obligations of firms under the regulatory system. It has complemented this with rules and procedures for regulated firms in an 8,000 page Handbook of Rules and Guidance. It has a range of disciplinary, civil and criminal powers which it can use against firms which breach the rules.

4 The FSA's principles[4] are that a firm must:

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

5 The FSA is highly regarded within the financial services industry in the UK and internationally and its risk–based approach is increasingly seen as a model to follow by other regulators. Financial markets during the first two years following the enactment of FSMA were highly volatile and unstable, but this has been followed by a generally benign external environment. During the last few years London has thrived as an international financial centre. Clearly, the FSA has to balance its responsibilities to maintain market confidence on one hand and protect consumers on the other. However, some financial services companies are concerned about the volume of rules within the FSA Handbook and the FSA's approach to regulation whilst consumer representatives emphasise the need for the FSA's approach to reflect the actual customer experience.

6 Since its establishment, the FSA has been in a state of continuous development and improvement. It has developed and applied a rigorous risk-based methodology to create a common language and approach to the very varied sectors and firms it regulates. Through this approach, the FSA has converged its operations, so it is not merely the amalgam of 11 previous approaches, but a coherent entity, with a consistent approach to the four elements of its objective.[5] The FSA has stated quite properly, however, that it could not, nor should not, address every conceivable risk to consumers and financial markets – it calls this a "non-zero failure" regime.

7 As a result of its success in creating a common methodology, the FSA in 2007 is an organisation rich in process. It recognises that it needs to develop further in two important and related areas.

8 Firstly, it has decided to become a more principles-based regulator. This means that it is placing greater reliance on firms adhering to its higher level principles, and a greater focus on the outcomes firms achieve for consumers and markets. It recognises that there are limits to the extent to which it can implement a fully principles-based system. In certain financial services markets, detailed rules will continue to play a role, for example where incentives for firms are directly opposed to achieving regulatory outcomes or where the need for direct comparability of information demands detailed provisions.[6] And although senior executives within firms support a more principles-based approach, legal departments in some firms may currently prefer the certainty of prescriptive rules. In addition, legislation from the European Union often goes to the detail of processes rather than setting higher level standards. For these reasons the FSA recognises that principles cannot entirely displace rules and that a balance is necessary, albeit tilted increasingly towards principles.

9 Principles-based regulation is most successful when it is used to mediate a relationship. The FSA's risk-based approach means that it has dedicated supervisors for the 1,000 largest regulated firms. It can therefore develop effective working relationships, including senior level engagement, with those firms. The FSA cannot develop the same relationship with the large volume of smaller firms. Instead it interacts with smaller firms mainly through regulatory returns, thematic visits and a contact centre. This carries the risk that these firms would be handled by less senior staff at the FSA. More principles-based regulation will therefore place additional requirements on the training and experience of the staff who interface with smaller firms so that the FSA communicates with these firms in an effective way.

10 Secondly, the FSA is increasingly aiming to move beyond process, and focus on the outcomes that it seeks to achieve. The FSA's new Outcomes Performance Report described in Part 1 of this report, provides its senior management and Board with a tool to measure the performance of the organisation against the outcomes it seeks to achieve. In our view, the development of an outcomes-focused framework is entirely consistent with and at least as significant as the FSA's move to more principles-based regulation.

11 Staff are the crucial ingredient for both these developments. Under more principles-based regulation, the FSA's supervisory and enforcement staff have more responsibility for judgements and decision making. The FSA recognises that it must therefore ensure that staff are of the right calibre and equipped with the necessary skills and knowledge. It announced in its 2007-08 Business Plan an additional investment of £50 million over a three-year period to improve the organisation, including the effectiveness of staff. This investment will fund, for example, training and development and improved knowledge management. It is also important that staff focus on the outcomes that matter. In our view, the Outcomes Performance Report, with nine high level indicators, can provide this focus.

The National Audit Office review

12 In June 2006, under section 12 of the Financial Services and Markets Act 2000, HM Treasury invited the National Audit Office to undertake a review of the economy, efficiency and effectiveness with which the FSA has used its resources in five areas of its operation. Our conclusions under these five headings and our recommendations, which are aimed at areas in which the FSA needs to improve, are as follows:

1. Performance management

The FSA has developed and is developing useful tools to manage its performance in meeting its objectives in an economic and efficient way. But it needs to enhance its grip on information on the cost of its activities, and must over time seek to streamline the new Outcomes Performance Report.

(a) matching the FSA's resource allocation to risks to its objectives and improving the processes

The FSA uses a consistent risk assessment process to allocate resources to its regulation of firms that pose the highest risk to its statutory objectives. It also has a comprehensive system for dealing with wider risks that may affect financial markets. But it does not yet have a similar process for prioritising resources at the highest level between its different functional areas, such as authorisation, supervision and enforcement. Its time recording system cannot at present identify the actual cost of its operational activities, such as supervising a particular firm (paragraphs 1.3 to 1.15).

The FSA should finalise its planned activity based costing system to allow it to record the total cost of individual projects, the cost of supervising larger firms and estimate the generic cost of supervising smaller firms. The system will also provide assurance as to whether the split of resources between its functional areas is appropriate. It should also monitor regularly the correlation between its risk assessments of individual firms and the amount of resources it uses to supervise those firms.

(b) the FSA's new Outcomes Performance Report

This Outcomes report represents an important step towards measuring the outcomes the FSA aims to achieve. It assesses outcomes based on 111 separate measurements and requires further testing and streamlining over time. The FSA aims to integrate the Outcomes report into its existing management information (paragraphs 1.19 to 1.27).

The FSA needs to streamline the number of measures that contribute to its new Outcomes Performance Report as experience of using it grows and also refine the Outcomes report to reflect the development of a principles-based approach to regulation. It should embed the Outcomes report as fully as possible into regular performance measurement and business management and planning processes.

(c) the effectiveness of the FSA's non-executive directors in reviewing economy and efficiency and the usefulness of the FSA's new "Economy and Efficiency Report"

The Financial Services and Markets Act 2000 requires the FSA's non-executive directors to review the economy and efficiency of the FSA and to report publicly thereon. This role has evolved over time. In practice, the whole Board monitors and assesses economy and efficiency, as a routine part of its responsibilities and using the same management information the non-executives use to review economy and efficiency in a separate committee. This is an appropriate development of the Board's role, consistent with the intentions of the Act (paragraphs 1.28 to 1.34).

It is possible that in the future the Act could be interpreted more narrowly, with the non-executives alone considering economy and efficiency. Although this situation has not arisen, it should remain clear that the non-executives' role in reviewing economy and efficiency does not displace the responsibilities of the whole Board on economy, efficiency and effectiveness.

2. Working with other UK regulators

The FSA has good and improving working relationships with other UK regulators. It should focus on working collaboratively with the Office of Fair Trading where the latter's interests in competition and consumer protection coincide with the FSA's interests in financial markets.

(d) relationships and sharing regulatory techniques and expertise with other regulators

The FSA has good and improving working arrangements with the Office of Fair Trading (OFT), the Pensions Regulator and the Financial Reporting Council, as well as with the Bank of England and HM Treasury in their arrangements for financial stability. The FSA and the OFT have recently concluded parallel projects on the sale of Payment Protection Insurance by financial institutions, the outcome of which showed effective joint working (paragraphs 2.1 to 2.32).

The FSA should now work with the OFT to capitalise on their respective strengths and avoid duplication and, in particular, seek to draw on the OFT's competition and market analysis expertise. This coordination could include running parallel projects in areas of common interest, or in some cases creating joint teams.

(e) future priorities for joint working with other regulators

The main priority lies in the FSA's joint working with the OFT. The effective coordination they have demonstrated shows how the FSA can draw on the OFT's competition expertise in situations where financial markets may not deliver a fair deal for consumers (paragraphs 2.17–2.19). The FSA should also continue to coordinate with The Pensions Regulator to ensure a clear understanding of their respective responsibilities for protecting the interests of pension scheme members and for improving their financial capability (paragraphs 2.20 to 2.24).

3. International influencing and representation

The FSA commits significant senior level resource to influencing international developments, where it is generally effective, but could sharpen up its communication to stakeholders about its strategy and contribution.

(f) influencing European financial supervision

The FSA has cooperated with other UK organisations to promote successfully the Better Regulation agenda in Europe. HM Treasury is the UK's principal negotiator on financial services and markets at the European Union and the FSA works closely with HM Treasury to develop the UK's position on emerging European legislation and its implementation. It is influential in European discussions and also engages effectively with the European Commission and other member states. The key elements of the FSA's strategy are disclosed each year in the FSA's annual business plan and International Regulatory Outlook. Stakeholders generally consider that the FSA does reasonably well in a complex and difficult environment, although some are unclear about the FSA's aims and approach in Europe or question the level of coordination with HM Treasury. This presents the Authority with a clear, but difficult, communication challenge to overcome (paragraphs 3.5 to 3.27).

The FSA should explain more clearly the respective responsibilities of the FSA and HM Treasury and the FSA's strategy for influencing and representation in the European Union. It can use existing publications such as the International Regulatory Outlook to do this. It should also continue to monitor the level and type of resources allocated to European activities to ensure they continue to be appropriate as the emphasis of the EU agenda moves from policy making to implementation effectiveness. Hence as the Commission begins to evaluate the impact of existing financial services Directives, the FSA can contribute its expertise in effectiveness reviews and cost-benefit analysis.

(g) influencing financial supervision outside the European Union

The FSA is a leading international regulator. It has achieved important results in global coordination, for example with the US regulatory authorities on administrative backlogs in the settlement of some types of financial instrument, and it is widely respected for its thought leadership on issues such as risk-based regulation. (paragraphs 3.28 to 3.32).

The FSA should take advantage of opportunities to promote greater coordination of approach among the regulators of the world's leading financial centres, for example on the supervision of multinational financial institutions.

4. Financial crime

Combating financial crime has tended to receive less attention than other elements of the FSA's responsibilities. But the FSA has recently restructured and enhanced its efforts. To make a success of this, it needs to review the assessments it makes of firms and the skills and training of its supervision teams.

(h) resources applied to combating financial crime (including counter-terrorist finance)

The FSA devotes under 10 per cent of its resources to its financial crime objective. The FSA could improve the effectiveness with which it uses the current level of resources and does not need to increase significantly the total amount of resource in the short term. It could also consider the weight it gives to financial crime risks within its risk assessments (paragraphs 4.5 to 4.25).

The FSA should examine the basis of its risk assessments to determine if it is appropriate to use size as a proxy for impact in financial crime and if greater weight should be given to smaller firms than at present.

(i) integrating the FSA's work on financial crime with its other supervisory work

The FSA has given greater emphasis to financial crime within its internal structure in recent months, consolidating three functions into a new Financial Crime Division. It did so to address concerns that financial crime issues had insufficient weight in the FSA's day-to-day supervision of financial institutions and its risk assessments (paragraphs 4.26 to 4.34).

The FSA's new Financial Crime Division should keep supervisory staff fully informed of, and help them develop their expertise in, financial crime issues.

(j) the integration of the FSA's work on combating financial crime (including counter-terrorist finance) with other agencies in this field

The FSA has recorded some important achievements in working with other UK agencies responsible for financial crime reduction in the UK. In particular it has acted as a catalyst to lead a wide range of organisations to adopt a common approach to financial crime issues (paragraphs 4.35 to 4.44).

(k) the FSA's communication and information sharing with business about financial crime

The FSA has increasingly encouraged financial institutions to adopt a risk-based approach, particularly in respect of their money laundering controls, so that institutions do not impose unnecessary identity checks on low risk consumers. The FSA's new approach has been widely applauded by financial institutions (paragraphs 4.45 to 4.51).

(l) the FSA's use of its enforcement powers and penalties

The FSA adopts a proportionate approach to using its enforcement powers on financial crime. It seeks to use criminal prosecutions and significant civil fines only for serious wrongdoing and uses a clear process of escalation to reflect the seriousness of the case. Business leaders increasingly perceive the FSA's approach as more effective than an alternative, more punitive approach, such as that taken by US regulators[7] (paragraphs 4.52 to 4.66).

5. Financial capability of consumers

The FSA is a world leader in financial capability. It should build on this by focussing on the costs of low financial capability and developing a medium term strategy for its financial capability programme beyond 2011.

(m) overall allocation of resources to financial capability

The FSA has taken a strategic lead in addressing financial capability. It identified low financial capability among UK consumers as a risk for financial services markets. To understand and address this risk, it carried out a comprehensive survey of current standards and has started to implement projects to improve financial capability. It plans to spend around £90 million in this area between 2006 and 2011. At present it cannot easily quantify the costs of low financial capability to society or how far it is helping to improve the situation so that it can judge if this allocation of resources is appropriate (paragraphs 5.1 to 5.19).

The FSA should aim to quantify the costs to society and the financial services market of low levels of financial capability to help determine long term plans for its role and resource allocation for this problem. It should also set measurable goals for improvements in consumer behaviour and outcomes against which success can be judged.

(n) working with other organisations on financial capability

In providing leadership and coordination, the FSA has played a major role in placing financial capability on the agenda of government and the financial services industry. The FSA is also working successfully with a range of partners to deliver its projects. It regards its role in building financial capability as long term and has set five year expenditure plans to provide certainty for industry and delivery partners. Links between the projects and between the National Strategy for Financial Capability and the FSA's other regulatory activity could be improved. The FSA has not yet set out its high level priorities and approach for its financial capability work post-2011 (paragraphs 5.20 to 5.35).

The FSA should identify the responsibilities it wants consumers to take on when interacting with the financial services markets and how its financial capability programme, alongside other regulatory activity, will help to equip consumers for these responsibilities. It is also important that the FSA, in consultation with stakeholders, begins in good time to develop its strategic priorities and approach for financial capability beyond 2010-11.

INTRODUCTION

This part provides background to the NAO review, covering:

- Section 12 of the Financial Services and Markets Act 2000;
- The regulated sector;
- The FSA's powers;
- The FSA's resources and activity;
- The development of the FSA.

Section 12 of the Financial Services and Markets Act 2000

The NAO was invited by HM Treasury to review the economy, efficiency and effectiveness with which the Financial Services Authority (FSA) has used its resources in discharging its statutory functions. The review is being carried out under Section 12 of the Financial Services and Markets Act 2000 (FSMA), rather than the National Audit Act 1983, as the NAO is not the statutory auditor of the FSA.

Under the terms of reference of the invitation, HM Treasury has asked the NAO to look at five broad areas of the FSA's work:

1. Performance management.
2. External joint-working in the UK.
3. Influencing and representation internationally.
4. Financial crime.
5. Financial capability.

The regulated sector

Financial services make up a significant part of the UK economy, in terms of employment, taxation revenue and economic production. The British Bankers' Association has estimated the sector's contribution in 2006 to be over one million jobs, and 25 per cent of total corporation tax.

London is one of the world's leading financial centres and financial services are a major source of wealth creation for the UK economy. The financial sector is the largest contributor to the UK balance of payments[8] and contributed 8.5 per cent of UK GDP in 2005. The recent environment in which the UK financial services industry operates has been relatively benign with no recession or other major shocks to the system.

The FSA is the principal statutory regulator of financial services in the UK, authorising and regulating deposit taking (e.g. banks), insurance, mortgage lending, general insurance advice (e.g. motor, home), mortgage advice and investment business. The FSA was one of the world's first 'unified' financial services regulators, taking over the role of eleven other bodies between 1997 and 2005.[9] It took on responsibility for mortgage regulation in 2004 and general insurance in 2005.

FSA's powers

The task of the FSA is to permit the development and discharge of legitimate financial business within a framework of systematic oversight that engenders trust in and compliance with the law among market participants and consumers.

It is common in financial services circles to refer to the 'twin peaks' of financial services regulation: market confidence and stability (known as prudential regulation) and consumer/investor protection (known as conduct of business regulation). These factors form a core part of the FSA's objectives, but are joined with a focus on financial crime and financial capability, so that in effect there are 'four peaks' of UK financial regulation.

The Financial Services and Markets Act 2000 (Part 1, Section 3) sets out four objectives for the FSA:

- Maintaining market confidence in the financial system.
- Promoting public understanding of the financial system.
- Securing the appropriate degree of protection for consumers.
- Reducing the extent to which regulated businesses can be used for financial crime.

Section 2 of the Act requires the FSA to have regard to:

- using its resources in the most efficient and economic way;
- recognising the responsibilities of regulated firms' own management;
- burdens imposed by regulation should be proportionate to the benefits;
- desirability of facilitating innovation;
- desirability of maintaining the UK's competitive position in financial services;
- minimising any adverse effects on competition; and
- desirability of facilitating competition.

The FSA's Board, appointed by HM Treasury, includes the Chairman (Sir Callum McCarthy), Chief Executive (John Tiner), the Managing Directors of its three business units, and nine non-executive directors (NEDs). There is additional external scrutiny from a statutory Financial Services Practitioner Panel and Financial Services Consumer Panel and a Smaller Businesses Practitioner Panel.

FSA's resources and activity

The FSA's operating costs for 2005-06 were £267 million. It employs 2,600 staff, as of March 2007 at an average gross salary of £55,000/year, reflecting the market conditions of the sector. The FSA is a private company limited by public guarantee, and funded by fees paid by the 30,000 firms that it regulates. The FSA's annual levies on the industry, which reflect the projected costs of regulation for that year, were £271 million in 2005-06.

The FSA has set out 11 Principles for Business which summarise the obligations of firms under the regulatory system **(Figure 1)**.

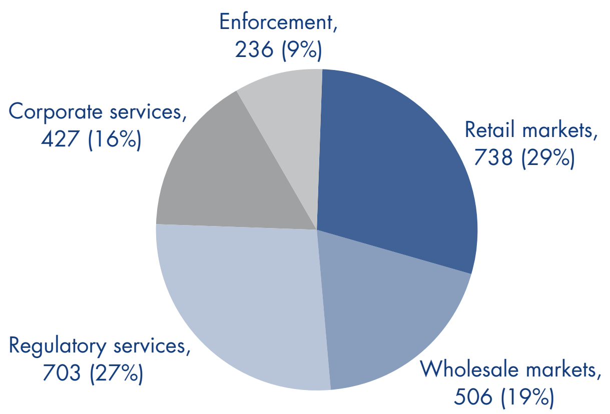
Alongside these Principles, the FSA has also laid down rules and procedures for regulated firms in an 8,000 page Handbook of Rules and Guidance.

1 The FSA's principles

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

The FSA's resources are separated into distinct functions: the supervision of retail and wholesale markets, enforcement, regulatory services and corporate services support functions **(Figure 2)**. Authorised firms[10] must meet standards set out in the FSA Handbook of Rules and Guidance. The supervisory relationship between the FSA and its authorised firms then depends on the level of risk that each firm poses to the FSA's statutory objectives. This risk assessment process groups firms into four categories with varying levels of supervision **(Figure 3)**.

2 Allocation of FSA staff between business areas



Source: FSA and National Audit Office

3 Categorisation of regulated firms according to risk

This figure shows that the FSA adopts a different supervision approach depending on a firm's risk category.

Risk category	Supervision approach	Approximate no. of firms
High	Close and continuous (e.g. eight person team covering HSBC)	90
Medium high	Regular cycle of visits	420
Medium low	Occasional visits	900
Low	Data collection/thematic contact/firms use call centres	27,560

Source: FSA and National Audit Office

If a firm breaches FSA's rules, enforcement action may follow, since enforcement represents one of the tools the FSA can use to deal with non-compliant behaviour. If enforcement action is taken the FSA has a range of disciplinary, civil and criminal powers which it can use against regulated and non-regulated firms. The sanctions include financial penalties, removal of authorisation or even criminal prosecution for a small number of cases of market misconduct. The FSA opened 269 enforcement cases in 2005-06 covering a variety of areas[11] and closed 227.

The FSA converts approximately two in every five cases it opens into formal action against the firms or individuals involved and took formal action in 81 cases in 2005-06. All cases which are concluded with disciplinary findings, including settled cases, are formally published. In 2005-06, 17 cases resulted in financial penalties, totalling £17.4 million.

The development of the FSA

The FSA was the first consolidated regulator of any of the world's major financial services markets. Since its creation, it has built a good reputation internationally and has consolidated the 11 separate regulatory approaches of its predecessors into a single risk-based model. This risk-based approach has created a common language and common approach to the very varied sectors and firms it regulates. The FSA has also clearly stated that it could not, nor should not, address every conceivable risk to consumers and financial markets – it calls this a non-zero failure regime. The risk-based approach is increasingly seen as a model to follow by other regulators.

Since its establishment, the FSA has been in a state of continuous development. As a result of its success in creating a common methodology, the FSA in 2007 is an organisation rich in processes. It is working towards becoming a 'more principles based regulator'. The FSA currently regulates with reference to both its 11 Principles for Business and more detailed rules and guidance. With its more Principles-based approach the FSA is aiming to effect a significant shift in emphasis with greater reliance on general principles, and less reliance on specific rules. The FSA will continue to communicate its requirements to firms through a combination of principles, high level rules and detailed rules in the Handbook.

The FSA recognises that there are limits to the extent to which it can implement a fully principles-based system. Although senior executives within firms support principles, legal departments in some firms may prefer the certainty of rules. In addition, legislation from the European Union often goes to the detail of processes rather than setting higher level standards. And in certain financial services markets, detailed rules will continue to play a role, for example where incentives for firms are directly opposed to achieving regulatory outcomes or where the need for direct comparability of information demands detailed provisions. This division is more than simply a difference between the wholesale and retail parts of markets. Rules are crucial in many elements of wholesale markets; principles are an important and growing factor in the regulation of retail financial services. For example, the FSA has developed an approach called Treating Customers Fairly for its regulation of retail financial services.

Principles-based regulation is most successful when it is used to mediate a relationship. The FSA's risk-based approach means that it allocates a dedicated supervisor to the 1,000 largest regulated firms and interacts with medium and smaller sized firms mostly through correspondence and a contact centre. The FSA is therefore able to develop close relationships, including senior level engagement, with larger firms. It cannot develop this relationship with all firms, because the large volume of small firms mean that the relationship is based on interaction through the FSA's contact centre, regulatory returns and thematic visits. As a result supervisors with well-developed understanding and relationships with large firms may find it easier to achieve the shift to more principles-based regulation. The FSA has a dedicated Small Firms Division which engages with small and medium sized firms to resolve major issues and maps and measures the main risks to identify areas in which firms need more support. The Small Firms Division can play an important role in helping smaller firms adapt to principles-based regulation.

Under more principles-based regulation, the FSA's supervisory and enforcement staff have more responsibility for judgements and decision making. The FSA recognises that it must therefore ensure that staff are of the right calibre and equipped with the necessary skills and knowledge. It announced in its 2007-08 Business Plan an additional investment of £50 million over a three year period to improve the organisation, including the effectiveness of staff. This investment will fund, for example, training and development and improved knowledge management.

In our interviews and discussion groups, the majority of participants expressed positive views about the FSA. But some raised concerns:

- firms welcome the theory of risk- and principles-based regulation but doubt whether this is consistently implemented on the ground by the FSA's supervision staff;
- smaller firms, such as financial advisers, find FSA's rules – such as information requirements for consumers buying financial products – burdensome; and
- consumer bodies question whether the shift away from rules offers sufficient protection to consumers who still suffer from mis-selling and poor understanding of financial products.

These concerns highlight the challenge facing the FSA on more principles-based regulation. It has to reconcile its vision with the reality of day to day supervision. And it has to ensure that its staff understand how to operate the principles-based approach and have the skills and capabilities to do so.

The FSA is also seeking to focus on the outcomes it seeks to achieve. The FSA's new Outcomes Performance Report[12], covered in Part 1 of this report, provides the FSA's senior management and Board with a tool to measure the performance of the organisation in relation to the outcomes it seeks to achieve. Under a more principles-based system, it is important that staff understand what outcomes to focus on. The Outcomes report can help staff develop this focus.

PART ONE

Performance Management

Summary

Effective performance management for the FSA is dependent on integrating risk assessment and measurement systems and business planning.

This section of the report shows:

- **matching the FSA's resource allocation to risks to its objectives and improving the processes**

  The FSA uses a consistent risk assessment process to allocate resources to its regulation of firms that pose the highest risk to its statutory objectives. It also has a comprehensive system for dealing with wider risks that may affect financial markets. But it does not yet have a similar process for prioritising resources at the highest level between its different functional areas, such as authorisation, supervision and enforcement. Its time recording system cannot at present identify the actual cost of its operational activities, such as supervising a particular firm (paragraphs 1.3 to 1.15).

- **the FSA's new Outcomes Performance Report**

  This Outcomes report represents an important step towards measuring the outcomes the FSA aims to achieve. It assesses outcomes based on 111 separate measurements and requires further testing and streamlining over time. The FSA aims to integrate the Outcomes report into its existing management information (paragraphs 1.19 to 1.27).

- **the effectiveness of the FSA's non-executive directors in reviewing economy and efficiency and the usefulness of the FSA's new "Economy and Efficiency Report"**

  The Financial Services and Markets Act 2000 requires the FSA's non-executive directors to review the economy and efficiency of the FSA and to report publicly thereon. This role has evolved over time. In practice the whole Board monitors and assesses economy and efficiency, as a routine part of its responsibilities and using the same management information the non-executives use to review economy and efficiency in a separate committee. This is an appropriate development of the Board's role, consistent with the intentions of the Act (paragraphs 1.28 to 1.34).

Matching resources to risk

1.1 The FSA has to decide how to allocate finite resources to meet its four statutory objectives. This depends on:

- a clear identification of the risks to its objectives;
- an effective assessment of the level of risk posed by different institutions; and
- an ability to allocate resources according to risk.

1.2 It is a risk-based regulator, which means that it assesses the risk posed to achieving its objectives by events, issues and firms, and then allocates resources to mitigate those risks. Its primary functions are:

- granting approval to firms and persons to operate in the financial services industry (Authorisation);
- supervising firms and persons to assess risks against the FSA's statutory objectives. Supervision is assisted by the FSA's 11 Principles for Businesses and the detailed rules in the FSA Handbook. Around 24 per cent of FSA staff carry out firm-focused supervision;
- enforcing these standards by sanctioning those who breach them, or those who operate without approval; and
- developing policy for the regulation of the financial services industry in line with proportionate costs and benefits.

1.3 A single risk assessment is made for each firm (or group of firms). Like any standard risk assessment, the decision is composed of an estimation of the probability of a risk crystallising, and the potential impact of that risk on the FSA's objectives of market confidence, appropriate consumer protection, reducing financial crime and improving public understanding of the financial system. In most areas of its work, the FSA tends to focus resources on larger firms, using size as a proxy for impact. For example, there is a team of eight staff responsible for HSBC plc. If a risk crystallises in a larger firm (e.g. insolvency), this poses a greater risk to market confidence, or a greater number of consumers, than if the same event occurs in a smaller firm. The FSA allocates a dedicated supervisor to the 1,000 largest firms, and interacts with smaller firms mostly via correspondence and a call centre.

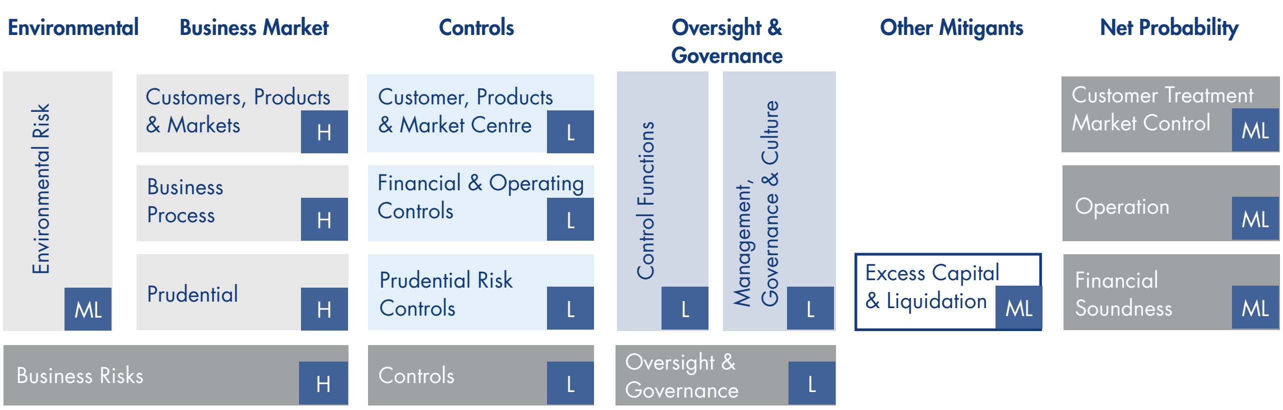
1.4 The Advanced, Risk-Responsive Operating FrameWork (known as ARROW) is the FSA's system to assess risk and decide where to focus supervisory activity. It aggregates a series of judgements about the risk levels for each firm for the following elements **(Figure 4)**:

- Environment risks (e.g. economic, legislative, competitive).
- Business model risks (e.g. customer and product characteristics, structure and ownership, people risk, IT systems, credit and liquidity risks).
- Control risks (e.g. accepting customers, market conduct controls, security of client money, IT security, credit risk controls).
- Oversight and governance risks (e.g. compliance monitoring, corporate governance, strategic planning, culture and management).

1.5 For smaller firms, the process to assess risk is carried out differently due to the much larger population of firms. Small firms, if applicable, fill in a Retail Mediation Activities Return. These returns are run through a computerised checking system which reviews 24 criteria from the reporting forms submitted by smaller firms.[13] This system generates alerts on areas of concern, and the FSA's Small Firms Division engages with the firm to resolve the issue. The Small Firms Division maps and measures the main risks in order to examine the areas in which firms are struggling and need more support. This can help inform decisions on undertaking thematic work to spread messages and good practice.

4 Example of the ARROW risk assessment framework

The FSA judges the level of risk: Low (L), Medium-low (ML), Medium-high (MH) and High (H), for each of the groupings, which provides an aggregated scoring on the far right of the model. In this example, the firm is scored overall Medium-low risk (in the Net Probability column).



Source: FSA

1.6 The FSA clearly defines its priorities, which it bases on a coherent risk assessment approach, and communicates this both internally and to the industry. This means that its supervisory function operates within a single, agreed concept of what constitutes risk, and allows the FSA to develop comparable assessments of risk across diverse sectors (e.g. banking versus insurance).

Risk reporting

1.7 The FSA uses three main tools for reporting risk: **(Figure 5)**.

1.8 Setting up the current risk architecture has taken around two years and it is now embedded across the FSA. A risk can be raised anywhere in the organisation, and then given a priority based on the impact and probability through a series of risk committees.

1.9 The effectiveness of this framework depends on:

- Comparability – the ability to compare risk is important and the ARROW model ensures comparability of risk assessment. The FSA, however, is still developing a common understanding of risk appetite.[14] The way in which risk appetite is expressed in different areas varies. For example, supervision areas may express risk appetite in terms of the minimum size that a firm needs to be before regular on-site visits need to be conducted, implying a tolerance for greater risk or uncertainty in smaller firms. Other areas of the FSA will describe their risk appetite differently.
- Quality control – the system is dependent on the quality of risk judgements. The FSA introduced review panels for the ARROW process, and the risk committees which challenge risk assessments at three levels provide quality control for wider risk reporting.

Allocating resources to risk

1.10 An important part of being a risk-based organisation is being able to monitor how effectively resources are allocated to identified risks. The FSA uses a time recording system called i-Time, which can provide data on the number of hours allocated to a task, although the time codes used are quite broad. The limitation of the system is, however, that the cost of those resources cannot be readily identified. This means that one hour of work recorded on i-Time by a Director cannot be easily differentiated from one hour of work recorded by a graduate recruit. As a result, the FSA is not able to cost activities precisely.

5 The FSA's main risk reporting tools

Tool	Description and purpose	Main user
Risk Dashboard	■ Risk database which is the FSA's core risk reporting, aggregation and analysis tool ■ Includes external risks (i.e firms, consumer risks, industry-wide risk) and internal FSA risks ■ Impact, probability, status of risk, and mitigation ■ Risk ratings challenged at 3 levels on quarterly basis ■ Only highest risks are presented to Executive Committee	Board (audit/risk committee) Executive Committee (and other risk committees)
Firms WatchList	■ A listing of the highest risk regulated firms ■ Includes details, possible implications and actions taken ■ Firms & Markets Committee add/remove firms monthly	Board Executive Committee Business Units
Interim Risk Manager (Records the outcomes and risks from ARROW assessments)	■ Holds all previous records of small firm returns and alerts generated ■ Database rather than reporting mechanism	Strategy and Risk Division Business Units Supervision areas
Alerts and Risk Indicator Engine	■ Reports rule breaches (alerts) and indicators of risk	Small Firms Division

Source: FSA and National Audit Office

1.11 Due to the constraints of this system, the FSA does not include high-level reporting of resources against risk in its management information. The National Audit Office asked the FSA's Risk Team to compare total FSA time spent against risk. **Figure 6** shows a relatively strong correlation between hours of work spent on a firm, against level of risk, which means that the FSA appears to be allocating resources effectively in terms of risk.

1.12 The National Audit Office survey asked FSA supervisors about the FSA's approach to risk. Nearly 80 per cent of respondents thought that the FSA usually identifies the key risks to its objectives. When asked whether the FSA allocates resources appropriately to focus on key risks, 46 per cent of respondents thought this was 'usually the case' and a further 46 per cent answered 'sometimes'.

1.13 Some parts of the FSA already monitor the allocation of resources to risk. For example, in 2005 the Wholesale Risk Committee reviewed the allocation of resources to supervising individual firms against risk scoring for those firms. The results led to a slight shift in resources between sectors.

1.14 The FSA clearly allocates resources according to risk at the level of individual firms. It is less clear, however, whether the FSA is able to allocate resources between its main activities – authorisation, supervision, enforcement and policy-making – on this basis. Its budgeting process identifies the core business activities that it must undertake each year, and then identifies additional priorities for further investment of resources. This approach has meant that the allocation of resources between its main activities has been broadly stable since the creation of the FSA.

1.15 The FSA can enhance its resource allocation system by implementing its activity based costing system (currently in development). This will help identify the fixed operational cost of core regulatory activities, and then help the FSA flex this for discretionary priorities.

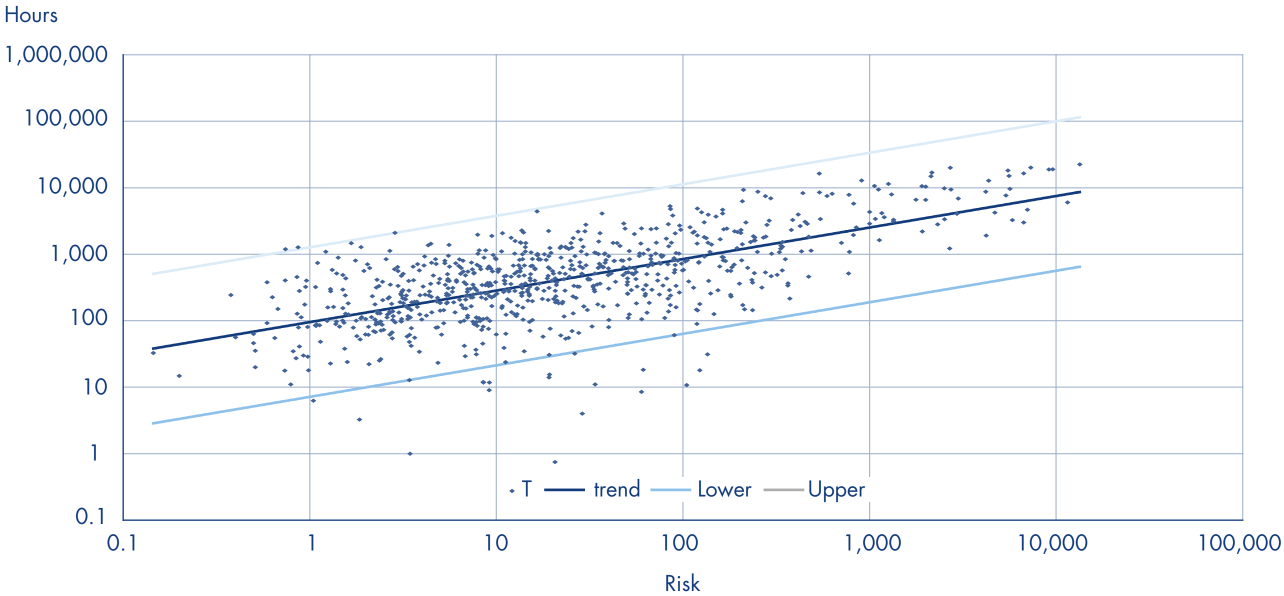
Measuring performance

1.16 The FSA is required by the Act to measure and report on its performance.[15] Performance measurement, therefore, has a very high profile within the organisation, with substantial resources dedicated to designing measurement tools, gathering data, reporting and analysis.

1.17 The performance management system has developed significantly since the creation of the FSA. Users of management information, notably the FSA's senior management and non-executive directors, told the National Audit Office that there has been continuous

6 Allocation of staff time to firms based on risk rating

Risk v Time (Logs) November 2003 to October 2006



Source: FSA analysis commissioned by the National Audit Office

NOTE

This Figure shows that the amount of time the FSA spends on a financial institution is broadly correlated with the risk posed by that institution.

improvement in the depth and quality of information over the past five years. The central Finance and Planning and Strategy and Risk Divisions provides corporate management information. In addition, each of the three business units have an operating office which produces management information for use within the unit, as well as for central reporting. **Figure 7** outlines the main performance reports produced.

1.18 The National Audit Office benchmarked the FSA's performance management system against the performance management maturity model in the National Audit Office's Efficiency Toolkit. This examines how well an organisation's approach to performance management links behaviour with business strategies. Overall, the FSA scores medium-high, indicating that it has a fairly mature performance management framework. This reflects the high profile of performance management at the FSA. Given the volume of management information, there is a risk that the process of measurement could displace time from acting on the information (see Appendix 1a).

The design of the new Outcomes Performance Report

1.19 The Outcomes Performance Report (the Outcomes report) was implemented for the first time in September 2006. It replaced an earlier performance measurement model. It aims to provide a single repository of performance information about how well the FSA is meeting its statutory objectives.

7 Summary of key performance reports used by the FSA

Report	Content
Executive Committee Management Information Pack Internal	■ 40 page pack presented quarterly to Executive Committee and Board ■ High-level data on Events, Risks (priorities from Risk Dashboard and Firms Watchlist), Resources, Performance (economy & efficiency, effectiveness, investment priorities, EU projects, service standards) ■ Continually evolving – recent packs have used different content and formatting
Business Unit Management Information Packs Internal	■ Produced by each of three Business Units for internal use. Some Divisions within units also produce their own very detailed MI packs ■ No set format – responsibility is devolved.
Economy and Efficiency Report Internal	■ Quarterly report for non-executive directors ■ Revised in 2005 to provide traffic light reporting of indicators ■ Discontinued in Oct 2006 – information now summarised in Executive Committee pack
Outcomes Performance Report Internal	■ Tool to measure FSA's progress in achieving outcomes ■ Developed throughout 2005 and 2006 ■ Based around nine indicators focused on consumers, markets and internal performance (supported by 111 metrics)
Performance Account Public	■ Published on FSA's website every six months ■ Reporting performance against 74 service standards (e.g. time to answer calls at call centres)[2] and annual project milestones ■ Focus on efficiency measures
Annual Report Public	■ Includes reporting on service standards, and, in the past, the Non-Executive Directors' report on economy and efficiency

Source: FSA and National Audit Office

NOTES

1 This figure shows that there are several layers of performance management reporting within the FSA, and regular changes to the reports produced.

2 http://www.fsa.gov.uk/Pages/Library/Corporate/Performance/archive/2006/standards4/index.shtml.

1.20 The Outcomes report is structured as a hierarchy of high-level goals and detailed measures. The FSA has translated its statutory objectives and principles of good regulation into three high level goals designed to be more meaningful to internal and external stakeholders. There are nine indicators under the three high level goals. They express in more detail what kind of outcomes the FSA aims to achieve for consumers, markets and in its own effectiveness **(Figure 8)**.

1.21 Each of these nine indicators is broken down into sub-indicators. For example, indicator seven ("The FSA is professional, fair, efficient and easy to do business with"), is broken down into four sub-indicators. The FSA considers these sub-indicators to be the crucial outcomes for staff to focus on achieving under a principles based system. Each sub-indicator has a number of metrics (Figure 33, Appendix 1b) which were selected based on *Choosing the Right Fabric: A framework for performance information*.[16]

1.22 The metrics rely on a wide range of data sources, many of which already exist and form part of other reports (e.g. results from the Financial Services Practitioner Panel survey, staff turnover rates, ARROW results, and market data). Other sources have been designed specially for the Outcomes report (e.g. the Consumer Purchasing Outcome Survey), but these have been developed in consultation with operational teams to ensure they have wider applicability. The Outcomes report will be reported on a six monthly basis. However, a number of the metrics, particularly those relating to consumer outcomes, will only be measured every few years and are likely to be slow to show trends. A high-level summary of the Outcomes report was included in the Executive Committee Management Information Pack for the first time in October 2006.

1.23 The Outcomes report has over 100 metrics. This high volume of metrics presents a number of potential challenges:

- Execution – feeding information into the Outcomes report takes time and requires input from a significant number of FSA staff each quarter;
- Reporting – it could be difficult to communicate the results and messages of the Outcomes report clearly and succinctly;
- Embedding it more widely – to date the FSA has focused on embedding the Outcomes report amongst senior management and other principal users. Over time the Outcomes report could become an important way of communicating the FSA's achievements and objectives to staff. In its present form, however, staff may find the detail confusing rather than enlightening; and

8 The nine principal indicators in the Outcomes Performance Report

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

Source: FSA

NOTE

This figure shows that there are nine principal indicators in the Outcomes Performance Report. More detailed extracts are shown in Appendices 1b) and 4b).

- Dealing with stakeholders – the FSA could publish the Outcomes report so that stakeholders are also clear about what it aims to achieve. At present, the FSA's published performance account mainly contains efficiency-related service standards.

1.24 Cost-benefit analysis (CBA) is integral to the FSA's achievement of its aims to be a proportionate, risk-based regulator. The Outcomes report includes a focus on CBA through Indicator 9, 'the costs and benefits of regulation are proportionate'. In June 2006, the FSA published three reports on the costs and benefits of its regulation, alongside its Better Regulation Action Plan Progress Report:

- **Cost of Regulation study:** commissioned jointly by the FSA and the Financial Services Practitioner Panel, this examines the incremental costs of complying with individual FSA rules to firms in three sectors – corporate finance, institutional fund management and investment and pension advice.
- **Estimation of FSA Administrative Burdens:** examines the costs financial sector firms and individuals incur in reporting to the FSA. Indicative results suggest that these costs are about £600 million, or about 0.5 per cent of the industry's total costs of around £120 billion.
- **Benefits of Regulation:** sets out a framework for identifying and measuring the benefits of regulation.

The FSA plans to use these studies to focus its Better Regulation work on rules where the costs involved may not be justified by the benefits they produce. It is important that its progress in achieving this is measured through the Outcomes report.

Developing and using the performance management system in the future

1.25 Over the last five years the FSA has developed a sophisticated approach to performance management. The performance tools it uses and its data gathering expertise are better than most of its UK and international peers. In relation to its new Outcomes Performance Report, the FSA's approach of starting with a comprehensive performance tool and refining it over time is sensible. As the FSA acquires more experience of using the Outcomes report and the results, it should consider how the performance tool can be developed to best support judgements on the extent to which the relevant outcomes are travelling in the right direction and any action that needs to be taken in response. This may be an iterative process, identifying the data that are easier to gather or most impactful on overall outcomes and which metrics are most useful to senior management in making decisions.

The Outcomes report also has great potential as a device for disseminating priorities and messages to FSA staff. This will need to be focused at the sub-indicator level or above.

1.26 The Outcomes report is concerned with measuring outcomes that describe FSA performance against its Strategic Aims. The FSA considers more principles-based regulation the best means for achieving the FSA's Strategic Aims. As the FSA moves to a more principles-based approach to supervision, it will need to monitor factors that promote or hinder this transformation – for example, by measuring the quality and consistency of staff judgements under indicator 7 (the FSA is professional, fair and easy to do business with). The FSA has recognised the importance of these issues and incorporated measures related to perceptions of its staff from the Financial Services Practitioner Panel Survey.[17] It could consider how to monitor changes in staff performance over time, rather than just static measures.[18]

1.27 There are four issues that the FSA should consider as it uses the performance management system:

- **Streamlining the system:** The FSA's performance management system has developed over the past few years. New measuring systems and reporting tools have been added. Over time the FSA should look to rationalise the number of items it measures. But it should avoid wholesale change to the system. Altering management information too regularly reduces the ability to identify trends.
- **Deciding how to use the Outcomes Performance Report:** The FSA is exploring the extent to which the Outcomes report links with other performance measurement tools such as the risk dashboard. The potential importance of the Outcomes report in helping FSA staff adapt to more principles-based regulation and the level of resource devoted to its development suggests the FSA should ensure the Outcomes report is fully embedded in its regular performance measurement.
- **Defining the acceptable results against the nine indicators:** the FSA should evolve a broad understanding of what it considers to be acceptable results against its performance indicators. This does not mean setting targets for every indicator. Instead, it requires a dialogue about the level of potential harm or risk the organisation is prepared to tolerate in these areas. The FSA has stated that it is a non-zero failure regulator: it does not intervene to protect consumers and society from every conceivable risk. The Outcomes report can help clarify what this means in practical terms. The FSA is intending, over time, for its senior management

to agree targets and weightings for each metric and sub-indicator, effectively setting risk appetites for specific parts of the FSA's performance and thereby influencing planning and resourcing. This approach is currently being piloted for Indicator 7: the FSA is fair, efficient and easy to do business with.

- **Ensuring the FSA acts on management information:** with any detailed performance management system, it is possible that so much effort goes into producing and reading the management information, that resources are diverted away from decision-making. The National Audit Office reviewed a series of management information packs and identified three indicators that had previously remained at a similar red risk rating for a prolonged period of time.[19] In all three cases, however, the FSA had taken clear and firm action to address the persistent red rating.

The role of the non-executive directors

1.28 The Act requires the FSA to have a governing body, with a majority of non-executive members. The Board of the FSA has nine non-executive directors. One of their key roles, required by the Act, is to "keep under review the question whether the Authority is…using its resources in the most efficient and economic way".[20]

1.29 To discharge this function, the non-executive directors have relied on data produced by the FSA, as well as referring to external sources. The Finance, Strategy and Risk Division produces a quarterly report for the non-executive director Committee (NedCo). From 2001 to 2005 this report was a descriptive summary of four areas (people, space, information systems and cash), with charts and tables as appropriate. From 2005 to mid 2006 it was based on indicators covering four areas of economy-related issues (cash, property & services, people, and knowledge & technology) and three areas of efficiency-related issues (core processes, management of resources against prioritised risk, and projects). From October 2006, in response to discussions with the Board, the FSA no longer produces a separate economy and efficiency report. The economy and efficiency indicators are now part of its standard Management Information Pack.

1.30 In reviewing the minutes of NedCo meetings in 2005 and 2006, the National Audit Office noted that most discussions about economy and efficiency centred on the nature of the reports produced for the Committee. At several meetings the Committee identified the need for the FSA to develop a more accurate understanding of how it is performing on economy and efficiency. This would require a more direct assessment of whether performance was "good or bad" instead of "better or worse" than the previous report.

1.31 The non-executive directors included a report on economy and efficiency in the FSA's Annual Reports for 2002-03, 2003-04 and 2004-05, which supported the statement on economic and efficient use of resources included in the Directors' Report. The Directors' Report described developments in the areas of People, Information, Space and Cash.[21] The 2005-06 Annual Report, however, had only a brief statement on economy and efficiency as part of the non-executive directors' report and no separate statement in the Directors' Report.[22]

The evolution of non-executive director's role

1.32 The National Audit Office held interviews with non-executive and executive Board members. We asked about the economy and efficiency role of the non-executive directors, how these issues are discussed in practice, and how they use management information provided by the FSA.

1.33 The interviews revealed some unease with the statutory responsibility for economy and efficiency placed on the non-executive directors. While they take their responsibility seriously, all the Board members interviewed felt that the statutory assignment is an unusual and artificial construct. There were two main concerns with the current requirements:

- Monitoring economy and efficiency should be the responsibility of the whole Board, not just the non-executive directors. Interviewees noted that it could be dangerous to imply that economy and efficiency is not the responsibility of executives, and that any Board would be deemed to have failed if it was left solely to the non-executive directors to challenge an organisation about economy and efficiency.
- This role has the potential to detract from the usual high-level, advisory role of the non-executive directors, and use up NedCo's scarce time. For example, detailed information in the reports on areas such as the cost of telephony per FTE may detract from the higher-level role of a non-executive director.

1.34 As the FSA and NedCo have matured, economy and efficiency monitoring has, in practice, become the responsibility of the whole Board. Economy and efficiency indicators are now included in the Executive Committee Management Information Pack, which is reviewed by the entire Board at its meetings. If the non-executive directors consider it necessary, they may request a complete set of economy and efficiency indicators to be presented to them separately, and will still discuss economy and efficiency separately at NedCo meetings. This leads to more appropriate governance arrangements, with higher-level reporting of a more targeted set of indicators to the Board.

PART TWO

Working with other UK Regulators

The FSA's effectiveness in working with other UK regulators depends on communicating, collaborating and liaising regularly; information and expertise sharing; and reducing administrative burdens on jointly regulated firms.

This section of the report shows:

- **relationships and sharing regulatory techniques and expertise with other regulators**

  The FSA has good and improving working arrangements with the Office of Fair Trading (OFT), The Pensions Regulator and the Financial Reporting Council, as well as with the Bank of England and HM Treasury in their arrangements for financial stability. The FSA and OFT have recently concluded parallel projects on the sale of Payment Protection Insurance by financial institutions, the outcome of which showed effective joint working (paragraphs 2.1 to 2.32).

- **future priorities for joint working with other regulators**

  The main priority lies in the FSA's joint working with the OFT. The effective coordination they have demonstrated shows how the FSA can draw on the OFT's competition expertise in situations where financial markets may not deliver a fair deal for consumers (paragraphs 2.17–2.19). The FSA should also continue to coordinate with The Pensions Regulator to ensure a clear understanding of their respective responsibilities for protecting the interests of pension scheme members and for improving their financial capability (paragraphs 2.20 to 2.24).

The Office of Fair Trading (OFT)

2.1 The FSA and the OFT have different but complementary powers and statutory objectives. Their interests coincide in a wide range of areas, from ensuring that markets work well, to informing, empowering and protecting consumers. Their roles sometimes overlap: for example, around 22,000 firms[23] are regulated by both the FSA and the OFT.

2.2 The FSA and OFT published a joint Action Plan in April 2006. The Plan marked a step change in the way the organisations worked together.[24] It identified areas where they can work more closely together e.g. communication with firms and consumers, and set out steps to reduce burdens on jointly regulated firms. The Action Plan is summarised at Appendix 2a).

2.3 The FSA and the OFT are exploring further opportunities for better joint working including:

- FSA involving the OFT in two key strategic areas: the review of the retail distribution system[25] and the post-implementation review of depolarisation[26];
- greater collaboration in respect of the Unfair Commercial Practices Directive and money laundering regulations; and
- a programme of short- and long-term secondments so that staff develop a practical understanding of the respective roles and responsibilities of each organisation.

Competition

2.4 Under the Competition Act 1998, the OFT has responsibility for enforcement of competition law in the UK. Some regulators, such as Ofcom and Ofgem, can exercise powers under the Competition Act, but the FSA cannot. Under Financial Services and Markets Act 2000, the FSA must have regard to competition[27], but this is not a primary objective. It therefore falls to the OFT to ensure that competition law is effectively applied in the UK financial services sector.

2.5 In addition to the Competition Act, the OFT has specific powers relating to financial services:

- Under Section 160(1) of the FSMA, the OFT has a duty to keep the regulating provisions and practices of the FSA under review.[28] Where the OFT considers that regulations may have a significant adverse effect on competition, it may make a report possibly leading to further action by HM Treasury.[29] The OFT has not used this power, and considers that this may have only limited relevance for regulations that derive from EU Directives (given the UK locus of the Act).
- The OFT receives copies of proposals on rule changes from the FSA, and can comment where appropriate, though it has not responded as a matter of routine.

2.6 In late 2003, the OFT launched a Financial Services and Markets Act Competition Review.[30] The objective of the review was to sift through markets affected by the Act to identify those areas that might raise competition concerns. The review did not find any indications that the Act had a significant adverse impact on competition in financial services markets. The review identified seven high level markets which exhibited either high levels of concentration or barriers to entry.[31] The OFT decided not to carry out further work into these seven markets because some had been recently examined by other bodies, such as the Competition Commission's report on banking for SMEs in 2000; in the area of clearing and settlement the EU had recently proposed legislation; and in other areas the OFT considered that there was insufficient evidence to embark on further work.

Consumer credit

2.7 The OFT operates the licensing system for consumer credit providers established by the Consumer Credit Act 1974. Some firms carrying on financial business with consumers are required to apply for authorisation to the FSA and apply separately for a consumer credit licence to the OFT. This is because some aspects of their business fall within the scope of FSMA, while others fall under the Consumer Credit Act. These businesses include banks, building societies, mortgage advisers and general insurance brokers.

2.8 The Hampton Report[32] suggested that the Government should consider the transfer of responsibility for consumer credit regulation from the OFT to the FSA. Following consultation with stakeholders, the Government concluded that a better regulatory outcome would be achievable without changing regulatory responsibility in this area. In this context, the FSA and the OFT recognised that they should work more closely together to improve the way in which they dealt with their jointly regulated firms.

2.9 Under the FSA/OFT joint Action Plan they carried out feasibility studies of the ways in which the administrative burden on jointly regulated firms could be reduced, including:

- **whether the FSA's authorisation and the OFT's consumer credit licensing processes could be aligned:**[33] They found that the number of firms affected would be relatively small.[34] Given this they considered that the cost to the two bodies of aligning their processes outweighed the benefits to this population of firms. This position has been endorsed by their industry user group.[35] Both the FSA and OFT are already developing online application systems which will deliver benefits to firms. They plan to revisit this area once both new systems are in place, to evaluate the costs and benefits of developing the systems further.
- **whether they could reduce the administrative burden on jointly regulated firms by making either the FSA or OFT solely responsible for collecting standing data changes, or by setting up a common interface for firms:** They found that there was no clear benefit to jointly regulated firms to change the current arrangements and this position was endorsed by their industry user group. Both the FSA and OFT have projects underway to develop systems that will enable firms to submit standing data changes online which should make it easier for firms to do business with both regulators.
- **whether they could rationalise the invoicing and collection of fees, so that in any one year a firm would receive a single invoice for fees due to the FSA, the OFT, Financial Services Compensation Scheme and Financial Ombudsman Service:** The benefit would be a reduction in the number of invoices received by firms but they considered that the cost saving would be minimal, particularly because firms make payments to the OFT only when applying for a licence or on renewal of that licence (currently every five years). The study proposed that no changes should be made to the existing revenue collection processes and this position has been endorsed by their industry user group.

2.10 The FSA's Enforcement Division and the Credit Licensing Investigation section of the OFT liaise about cases and issues of common interest. In particular, designated contacts from the respective teams meet regularly to discuss cases and exchange information where appropriate. There has been an increase in liaison between the FSA and OFT about cases and issues of common interest. However, the nature of the information disclosure gateways (particularly on the FSA side) restricts but usually does not prevent disclosure between the two organisations.

Consumer protection

2.11 The FSA and the OFT share a common interest in consumer protection. One of the FSA's four statutory objectives includes protecting consumers of financial services, and the OFT's overall objective is to make markets work well for consumers.

2.12 Both the OFT and FSA have powers over unfair contract terms under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). They agreed a revised Concordat in July 2006. This commits the FSA and OFT to take necessary and proportionate action where there is evidence of a potential breach of the UTCCRs causing consumer harm. It also means that firms, in normal circumstances, are given a reasonable opportunity to stop relying on unfair terms, removing or revising them as appropriate, before formal action is taken. It will ensure that there is no duplication of effort and that action is taken by the body best placed to lead on any given issue. Under the new Consumer Credit Act 2006 consumers can access the Financial Ombudsman Service (FOS) for consumer credit complaints concerning firms that are licensed by the OFT but not authorised by the FSA.

2.13 In April 2006, the OFT published its findings on default charges in the credit card market. In September 2006, the OFT and the FSA announced that, in view of its work on default charges in the credit card market, the OFT would take the lead on a further piece of work looking at default charges on banks' current accounts.[36]

Sharing Information

2.14 The FSA is subject to statutory restrictions on disclosing confidential information it has received about third parties. The restrictions do not apply to any information that the FSA has originated itself, or where it has obtained the consent of the provider of the information. But where the restrictions do apply the FSA can only pass confidential information about firms through a gateway (a statutory exception to these restrictions). Different restrictions apply depending on how the FSA obtained the information in question.

2.15 Under the Financial Services and Markets Act 2000 and the 'Disclosure Regulations', only limited gateways exist to disclose information to the OFT.[37] In particular, regulation 9 of the Regulations restricts the FSA's disclosure of confidential information obtained under EU single market directives. The current operation of this gateway might restrict the OFT's competition functions and means that there is a large category of information that the FSA cannot disclose to the OFT. HM Treasury are now reviewing the Disclosure Regulations and may amend them.

2.16 The Consumer Credit Act 2006 may have a positive impact on information sharing because under the new Act the OFT will gain new "supervisory" functions that it does not currently have, which may provide a gateway and increased scope for the FSA to pass information to the OFT.

Sharing expertise

2.17 The OFT's competition powers give it responsibility for applying competition law over major sectors of the UK economy. It has developed expertise in looking at competition matters in non-FSA areas of financial services, in particular consumer credit, one of its five priority areas as described in the OFT's Annual Plan 2006-07. However, the financial services sector is complex, and specialist knowledge is often required. If the OFT undertakes work on financial services, it should draw on the FSA's expertise.

2.18 The FSA and the OFT have worked together successfully on the issue of Payment Protection Insurance (PPI), taking advantage of their different but complementary perspectives. The FSA is primarily concerned with how financial institutions conduct their business, while the OFT is more concerned with the operation of the market. Developing a relationship through which the FSA focuses on the behaviour of financial institutions and the OFT more on market outcomes provides a model for future successful joint working between the two organisations **(Figure 9 overleaf)**. They can also use the comparative advantage that each body has in the penalties and remedies they can recommend to achieve an outcome that is beneficial to consumers. The FSA can speedily address consumer detriment for customers of a specific firm found not to be observing the FSA's principles and Rulebook by fining the firm or by imposing a public censure (as they have done following their PPI work[38]). The OFT can consider whether remedies might be appropriate and make recommendations across all the firms in the relevant market if they undertake a market study that finds that the market is not working well for consumers. However, a market study (with a possible referral of the matter to the Competition Commission to undertake a formal market investigation) can take a lot longer to reach a conclusion than the penalties available to the FSA.

2.19 The FSA and the OFT intend to collaborate on, or should explore closer collaboration on:

- **Supervision:** The Consumer Credit Act 2006 extends the OFT's existing supervisory functions by introducing a change to the fitness test applied to applicants for consumer credit licences. In certain circumstances, the OFT may undertake an on site assessment of credit competence. The FSA may share its extensive knowledge and experience of supervision with the OFT.

9 Case study – Payment Protection Insurance

The FSA took responsibility for regulating the insurance market in January 2005. It decided to review the selling practices of payment protection insurance (PPI), which is widely available to consumers of credit products and protects the borrower's ability to keep up the payments on a loan in case of accident, sickness or unemployment. It carried out this project between May and October 2005, with supervision visits to 45 firms selling PPI and a mystery shopping exercise. It published its report in November 2005 and subsequently completed a second round of visits to a further 40 firms selling PPI.

In the course of analysing the results, it became apparent that as well as compliance problems with the sales process, there were problems arising from the operation of the market caused by the lack of effective competition at point of sale. The FSA considered that these issues were more appropriately dealt with by the OFT as a competition regulator. In addition, PPI is often sold alongside a credit agreement, which meant that the OFT as regulator of consumer credit had a regulatory interest in this area.

In September 2005 the Citizens Advice Bureau published a report on PPI with recommendations to both the FSA and the OFT. At the same time they submitted a super-complaint to the OFT on PPI. In response the OFT decided to conduct a market study on PPI which it launched in April 2006.

The results of the OFT's examination gave it grounds to suspect that there were features of the market which restrict competition to the detriment of consumers. Despite some evidence of a degree of consumer satisfaction with aspects of the product, they considered that the evidence, as a whole, suggested consumers got a poor deal. The OFT decided to refer the matter to the Competition Commission in February 2007 to undertake a thorough investigation of the market and, if necessary, ensure that appropriate remedies are put in place.

In reaching this decision the OFT took account of the work which the FSA is doing to remedy the problems relating to selling standards, as well as the various industry initiatives which are underway in response to the FSA's work. However the OFT and FSA agreed that the FSA's action targeted at selling practices alone cannot remedy the lack of competition that the OFT identified in the PPI sector.

During this project the two organisations shared information, including data on firms which the OFT used to select a sample for their business survey, and providing the documentation that the FSA collected from firms during their mystery shopping work. The FSA provided the OFT with a high level market failure analysis identified from its work, which provided input to the OFT's consideration of the super-complaint and early work on its market study. And the FSA sat on the OFT's steering group, the first time that the OFT has had an external organisation represented on such a steering group. Overall, trade associations consider that, after an uncertain start when they appeared to be uncoordinated, the PPI project exhibited effective joint working between the FSA and the OFT.

Source: National Audit Office

- **More principles-based regulation:** With the FSA's move to a more principles-based approach to regulation, it recognises that there is a potential role for industry codes to clarify and support its principles. The OFT has developed a consumer codes regime through which it approves codes developed by a particular industry. The FSA and the OFT worked collaboratively on their formal responses to the Banking Codes Review, and should continue to do so.[39]
- **Consumer protection:** The FSA, the OFT and the FOS all have a role in the protection of consumers of financial services, and can work together in raising awareness and clarifying their respective roles in relation to consumer financial services complaints and financial capability and education work where appropriate.

The Pensions Regulator (TPR)

2.20 The FSA does not regulate occupational pension schemes. But it does regulate firms which provide investments and investment services to occupational pension schemes. The FSA also has a statutory objective to promote public awareness and understanding of the financial system, which extends to all forms of pension provision.

2.21 The Pensions Regulator's objectives are to protect the benefits of members of work-based pensions, reduce the risk of situations arising where there may be a call on the Pension Protection Fund, and promote the good administration of work-based pensions. It is primarily concerned with ensuring the good administration of work-based schemes and protecting members' benefits. It was created by the Pensions Act 2004.

2.22 The FSA and the Pensions Regulator have sought to minimise the risk that investment firms face two regulators with conflicting approaches for pension business. In April 2005, they agreed a Memorandum of Understanding (MOU) which sets out the arrangements for co-operation, co-ordination and the exchange of information. There was an initial period where there was no statutory instrument in place to allow the exchange of information.[40] This did not cause any significant issues. The FSA and the Pensions Regulator share information effectively.

2.23 Issues on which the FSA and the Pensions Regulator currently coordinate and need to continue to collaborate closely include:

- **Secondary markets:** The UK pensions market has seen sponsoring employers increasingly keen to reduce the risk that they have to eliminate current or future pension deficits. The market has responded by developing schemes involving transfer of liabilities to a third party. The intention of pensions legislation is that employers can only fully discharge their responsibility to eliminate deficits by transferring to a regulated insurance company. But in some cases schemes have instead involved transferring liabilities to a nominal employer. Such an entity would take on a similar responsibility to an insurer but would lie outside the scope of FSA insurance regulation and may not have the regulatory capital to provide the appropriate guarantee. The FSA and TPR have worked together as the TPR has developed guidance for pension scheme trustees on handling such proposals.
- **Changes in the nature of pension schemes.** Pension schemes are increasingly shifting from a trust basis, where the assets of the scheme are held by trustees on behalf of the members, to a contract basis, where each individual member holds a contract with the scheme.[41] While trust-based schemes are entirely the responsibility of TPR, regulatory responsibility for contract-based schemes is shared between TPR and the FSA. This is because FSA regulates the sales and marketing of personal pensions and related products, including pensions provided on a contract basis. It is also responsible for the authorisation of the insurance firms who provide these products and the investment firms that manage the investments.[42]
- **Financial inducements:** There has been growing concern about the offer of inducements to pension scheme members. An inducement is where an employer offers scheme members a financial incentive to change the basis of their pension – for example, away from a pension based on final salary at retirement. Although offering inducements is not illegal and advice on them is not regulated by the FSA and TPR[43], both bodies have collaborated on the issue, leading to the publication of guidance by TPR.[44]
- **European coordination:** The FSA and TPR are both members of the Committee of European Insurance and Occupational Pensions Supervisors.
- **Risk and principles:** Both the FSA and TPR have collaborated in developing their sophisticated risk-based approaches and are exploring a focus on principles. The two organisations should continue to compare their risk models to ensure that they learn from each other.

2.24 In January 2007 the Minister of State for Pension Reform announced an independent review of the institutions involved in the regulation and protection of work-based pensions. The review will examine how the responsibilities of pensions institutions – such as TPR, Pension Protection Fund, and the Financial Services Authority – fit with the Government's pension reform proposals. The review will be completed and report to Ministers in spring 2007.

Financial Reporting Council (FRC)

2.25 In some countries, a single body is responsible for securities regulation and enforcing audit and accounting standards, whereas in the UK these responsibilities are divided between the FSA and FRC and its operating bodies.

2.26 The FRC is the UK's independent regulator for corporate reporting and governance. The FRC has a number of bodies that operate under its aegis, including the Accounting Standards Board (ASB), the Auditing Practices Board, the Board for Actuarial Standards, the Public Oversight Board and the Accountancy Investigation and Discipline Board. The FSA has a close interest in high quality accounting, audit and actuarial standards in the UK. In particular, the FSA as Listing Authority has a close concern with the integrity of financial information provided to the capital markets. The FSA therefore has an extensive network of relationships with the FRC and its operating bodies, with the most interactions being with the Financial Reporting Review Panel (FRRP). In addition, there are several meetings each year between the FSA, FRC, DTI and HM Treasury at which senior management are present, and one of the FSA's Managing Directors is a member of the FRC's Council.

2.27 Formal information flows are limited by legal constraints on the FSA's powers to pass information to the FRC. The FSA is allowed to disclose information for the purpose of enabling it to carry out its own functions, but its powers to disclose information to assist other organisations have been limited in the past by EU directives. As a result, the FRC asked HM Treasury to look at extending legal gateways for the passage of information, particularly to cover recent extensions to the FRRP's functions[45]. The gateways were extended by statutory instrument in late 2006.[46]

2.28 There are strong working links between the FSA and the FRRP. The two bodies agreed a Memorandum of Understanding in July 2005 which works well. They collaborate on the Committee of European Securities Regulators and are both members of the Committee's European Enforcers Co-ordination Session. In addition the FSA and the ASB liaised closely over International Accounting Standards on accounting for financial instruments. Finally, the FSA collects the FRC's levy on listed companies at the same time as it collects its own fees, thereby reducing the costs of collection and the administrative burden on authorised firms.[47]

2.29 There are a number of issues on which the FSA and the FRC continue to liaise:

- Each year the Financial Reporting Review Panel prioritises sectors that will form the focus of its monitoring activity, based on a risk based assessment. The FSA provides the Panel with advice on developments in financial markets and they have adopted a risk-based approach which is similar (at a high level) to the FSA's methodology.
- There are currently only four firms auditing the majority of listed companies. The concentration in the market represents an issue for the FSA (who seek to maintain confidence in financial markets) and for the FRC (who focus on ensuring audit quality). The FSA and the FRC discuss developments in the audit market regularly.
- Both bodies have an interest in the development of the FSA's Listing Rules. They liaise closely, though the FRC noted that the FSA has at times made changes to the Listing Rules without consulting the FRC.

2.30 On likely future issues, institutional changes are underway at the European level. A new committee – the European Group of Audit Oversight Bodies (EGAOB) – was established in early 2006 on which the FRC represents the UK, and the Company Law Directive comes into effect in 2008. The creation of this new committee will necessitate the continued close co-operation by the FSA and the FRC.

2.31 The FRC adopts a principles-based approach, for example in its Combined Code on corporate governance. This leaves companies scope for judgement on how to apply the requirements of the Code, including a "comply or explain" provision to allow for argued exemptions. As the FSA itself moves towards a more principles-based approach, it can learn from and share its experience with the FRC.[48]

Joint working with other bodies

2.32 The FSA also liaises with other bodies in the UK:[49]

- The **Financial Ombudsman Service (FOS)**[50] is operationally independent of the FSA, although the FSA is responsible for the overall regulatory framework.[51] The Financial Services Practitioner Panel report in November 2006 indicates that practitioners they surveyed who had had dealings with the FOS, perceive there is still some disconnect between the FOS and the FSA, in particular that the FOS is assuming a policy setting role that is the responsibility of the FSA. The FOS provides regular updates to the FSA on the main issues it confronts and the FSA and the FOS have dedicated teams to liaise with one another, and a published process for dealing with wider implications cases.[52] The relationship between the FSA and the FOS goes beyond the terms of reference of this review, and maybe affected by the statutory framework between the two bodies.
- The **Financial Services Compensation Scheme (FSCS)**[53] is operationally independent of the FSA, although the FSA is responsible for the overall regulatory framework.[54] The FSCS provides regular updates to the FSA on the main issues it confronts and the FSA and the FSCS have dedicated teams to liaise with one another.

- The FSA, **HM Treasury** and the **Bank of England** share responsibility for maintaining the UK's financial stability, through the "Tri-partite" arrangements. The roles and the division of responsibilities between the three authorities are spelt out in a published Memorandum of Understanding which was updated in 2006. Under these arrangements the authorities explore risks to financial stability and the resilience of the UK financial system to withstand shocks. Their resilience project, which examined the resilience of the system to operational disruption, is the most comprehensive study of financial sector resilience and recovery arrangements ever undertaken, and includes consideration of a wide range of risks, including terrorist attack and the consequences of a natural disaster. They have also conducted periodic tests to develop their ability to manage a potential financial crisis.
- The **Banking Code Standards Board** is a body with independent governance, and its role is to monitor compliance with and enforce the Banking Codes and to ensure subscribers provide a fair deal to their personal and small business customers. The Banking Code is sponsored by the British Bankers' Association, the Building Societies Association and APACS, the UK payments association. The Business Banking Code is sponsored by the British Bankers' Association and APACS. The codes cover current accounts (including basic bank accounts), personal loans and overdrafts, savings and deposit accounts (including cash ISAs and cash deposit Child Trust Funds), payment services, cards and PINs. The FSA has not generally imposed detailed conduct of business regulation on the deposit-taking business of subscribers to the Banking Codes, except where required by European law. The Banking Codes are therefore the main source of conduct of business standards for Codes subscribers. The Banking Codes are currently subject to an independently led triennial review. The FSA and the OFT worked collaboratively on their formal responses to the Banking Codes Review.

PART THREE

Influencing and representation internationally

The FSA's effectiveness in influencing and representation internationally requires: it to be clear on what it aims to achieve; effective co-ordination with other parts of UK Government, in particular HM Treasury; close engagement with EU and international institutions; and clear communication of these activities to the UK financial services industry who are affected by EU and international regulatory developments.

This section of the report shows:

- **influencing European financial supervision**

  The FSA has cooperated with other UK organisations to promote successfully the Better Regulation agenda in Europe. HM Treasury is the UK's principal negotiator on financial services and markets at the European Union and the FSA works closely with HM Treasury to develop the UK's position on emerging European legislation and its implementation. It is influential in European discussions and also engages effectively with the European Commission and other member states. The key elements of the FSA's strategy are disclosed each year in the FSA's annual business plan and International Regulatory Outlook. Stakeholders generally consider that the FSA does reasonably well in a complex and difficult environment, although some are unclear about the FSA's aims and approach in Europe or question the level of coordination with HM Treasury. This presents the Authority with a clear, but difficult, communication challenge to overcome (paragraphs 3.5 to 3.27).

- **influencing financial supervision outside the European Union**

  The FSA is a leading international regulator. It has achieved important results in global coordination, for example with the US regulatory authorities on administrative backlogs in the settlement of some types of financial instrument, and it is widely respected for its thought leadership on issues such as risk-based regulation (paragraphs 3.28 to 3.32).

Influencing and representation at the EU level

3.1 The European Commission's objective is to promote the European internal market in financial services to enhance European competitiveness and bring economic benefits. Its Financial Services Action Plan consists of 42 measures covering a wide range of areas including investment funds and services, capital requirements, prospectuses, accounting, pensions and reinsurance. In recent years most new financial regulations have derived from Europe, rather than the UK Government or the FSA. There is some unease in the UK financial services industry (including the FSA) about whether the compliance burdens imposed by European-derived regulation can always be justified in cost benefit terms.[55]

3.2 For example, the FSA has recently published a commentary on the overall costs and benefits for the UK of the Markets in Financial Instruments Directive (MIFID) **(Figure 10)**.[56] This shows that the overall costs and benefits of MIFID are difficult to estimate with precision. In particular the quantification of benefits is problematic. The FSA's commentary also noted that the benefits for emerging EU markets are likely to be more significant in relative terms than for fully developed markets like the UK.

3.3 For each directive, it can take several years from initial negotiations to final implementation in Member States. For example, **Figure 11** shows the timeline for MIFID which started with a Commission consultation on upgrading the Investment Services Directive in November 2000 but which will not be implemented in Member States until November 2007. MIFID is the FSA's largest single project in terms of staff resource. Since March 2005, the FSA has spent some 18,200 days on its MIFID implementation project.

10 Case study – Assessment of the costs and benefits of the Markets in Financial Instruments Directive (MIFID)

To demonstrate the importance they attach to the value of cost-benefit analysis and given the wide-ranging nature of MIFID, the FSA and HM Treasury decided to comment on the costs and benefits of the MIFID directive.[1] The FSA published their estimates in November 2006 which attempted to assess the overall costs and benefits of MIFID for the UK.

Broadly the FSA estimated that MIFID could plausibly be estimated to generate quantifiable benefits of up to £200 million per year in direct benefits, accruing principally to firms in the form of reductions in compliance and transaction costs (and another £240 million in 'second round' effects[2]). On the costs side, they estimated quantifiable one-off costs of some £877 million to £1.17 billion for firms and additional on-going costs of £88 million to £117 million per year.

Source: National Audit Office

NOTES

1 Joint Implementation Plan for MIFID, May 2006.

2 These benefits, which are contingent on the direct benefits arising and are thus subject to some additional uncertainty, would accrue to the economy as a whole from deeper and more liquid capital markets rather than to individual firms.

3.4 The process by which the European Commission makes, implements, monitors and enforces financial services legislation is based on the proposals of the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Lamfalussy.[57] This approach has created four stages or "levels": framework principles, implementing measures, co-operation and enforcement. A number of legislative proposals central to the Financial Services Action Plan have been taken through this specific legislative procedure developed to keep pace with fast evolving financial markets.

The role of the FSA in Europe

3.5 The Government is responsible for the negotiation of legislation originating in the EU affecting financial markets, providers and consumers of financial services. In practical terms, this means that HM Treasury leads on the negotiation of most of the legislation affecting financial services, as well as leading the UK's representation to EU institutions, together with the UK's Permanent Representative, on strategic issues, such as the future direction of financial services policy in Europe.

11 The timeline for the implementation of MIFID

Level 1 – Framework directive	**Date**
Commission consultation on upgrading the Investment Services Directive	16 Nov 2000
Commission proposal	19 Nov 2002
European Parliament First Reading	25 Sep 2003
Parliament Second Reading	30 Mar 2004
Directive adopted	27 Apr 2004
Level 2 – Detailed implementing measures	
Commission formal request for CESR[1] technical advice on possible implementing measures	25 Jun 2004
CESR delivers first advice to the Commission	3 Feb 2005
CESR delivers second advice to the Commission	3 May 2005
Commission releases draft implementing measures for MIFID	6 Feb 2006
EU Parliament adopts technical measures for implementing MIFID	15 Jun 2006
ESC[2] adopts technical measures for implementing MIFID	26 Jun 2006
Publication in EU Official Journal of implementing measures under MIFID	2 Sep 2006
Transposition date into UK law	31 Jan 2007
Implementation deadline for MIFID in the UK	1 Nov 2007

Source: National Audit Office

NOTES

1 The Committee of European Securities Regulators.

2 The European Securities Committee.

3.6 In the context of the Lamfalussy procedures outlined above, this means that the Treasury represents the UK at the framework legislation stage, (negotiated for the most part under the codecision procedure), and on the supporting committees (negotiating more detailed implementing measures beneath the framework legislation). The FSA takes part in the committees of regulators known as the "Lamfalussy committees" - but these do not have a legislative function. Under FSMA, the FSA is also responsible for detailed implementation of the resulting legislation into UK law, and its enforcement, although the Treasury is responsible for amendments to primary legislation to ensure the FSA has the necessary powers. The Government is ultimately accountable as a signatory to the Treaty and would deal with any infraction proceedings. This split of responsibilities differs from the domestic picture, where the responsibility for many decisions and rules lies with the FSA.

3.7 The Lamfalussy committees of national regulators provide detailed, professional advice to the European Commission on the technical implementing provisions or secondary legislation needed to flesh out Directives. The committees also provide a forum where issues of common concern and potential solutions can be discussed and where supervisory convergence can be advanced. The FSA represents the UK in the committees of national regulators. The relationship between the Lamfalussy committees and other key EU institutions is illustrated at Appendix 3a.

3.8 This structure creates a series of constraints on the FSA's capacity to shape the development of European financial regulation and means it can seek to influence, but cannot ultimately control, the outcome of negotiations in Europe:

- The UK is one of 27 Member States in the EU, and decisions in the Council are taken by qualified majority voting.[58] This means that decisions do not need unanimity across all Member States before they are passed, and so no one state can hope to control the process.[59] As a Member State, the UK must implement EU law in the UK.
- All Member States have an interest in directives that affect the retail markets. A smaller number has an interest in proposals affecting wholesale financial markets. The UK, as a leading global financial centre, has a keener interest in new regulations affecting wholesale markets than other Member States. In general, stakeholders we interviewed considered that the FSA has been influential on the regulation of wholesale markets and had done well in a difficult environment where the UK has few natural allies. However, the regulation of retail markets is driven by domestic political agendas in each Member State. Stakeholders generally considered that, for these reasons, the FSA had not influenced negotiations to the same degree.
- Negotiations in the EU involve national and political sensitivities. This means that HM Treasury may judge that the UK's wider interests are best served if it agrees to a compromise on some issues. As a consequence, the FSA may have to accept a less than optimal outcome in negotiations on a financial services directive. Conversely it can be difficult for the FSA to promote its own successes to UK stakeholders without potentially destabilising relations with non-UK audiences in Europe.
- The European Commission has increased the number of "maximum harmonisation" legislative measures as a way of imposing common rules in specified areas which they consider is more effective at delivering a coherent single market. Effectively this approach works as an "anti-gold plating" clause. It prevents national regulators introducing regulatory additions at a national level. The FSA disagrees with this as a general approach and considers that a high level, principles-based directive should enable sufficient convergence, whilst allowing room for manoeuvre in implementation to address country-specific risks.[60] The use of "maximum harmonisation" by the Commission may constrain the FSA by removing aspects of consumer protection for UK consumers. For example, the FSA considers that the "maximum harmonisation" approach on MIFID implementing measures may significantly limit the scope to add or retain Conduct of Business requirements on firms that the FSA regards as central to the maintenance of consumer protection. In some areas of MIFID the FSA has sought to retain requirements which go beyond the Commission's measures.
- The European Central Bank (ECB) is increasingly looking to influence European financial services regulation. The Bank is an advocate of a single EU rule book for banking services. It has also proposed Europe-wide regulation of settlement services in the "eurozone", even though the Commission had adopted a Better Regulation approach in the form of an industry code on clearing and settlement with infrastructure providers, thereby delivering an alternative to legislation.[61]

Resources devoted to EU work

3.9 The FSA decided in 2004 that responsibility for European Union and international representation on specific issues should lie with the line managers who have the relevant sector-specific expertise and are responsible for the respective domestic policies. While European and international policy work is embedded in the FSA's business units, the FSA also considered that it was important that the FSA had the capacity to maintain an overview of international policy developments and established a strengthened International Strategy and Policy Co-ordination Department. The Department helps FSA senior management to influence thinking on European and international policy at an early stage and monitors developments.[62] The Department also acts as the FSA's relationship manager with a number of key stakeholders in the international arena.

3.10 Representatives of the FSA's senior management sit on the main committees of national regulators that provide technical advice to the Commission and they have chaired influential sub-committees such as:

- CESR[63] Expert Group on MIFID Intermediaries (FSA's Chairman).
- CESR Operational Group: Enforcement of Financial Information disclosed by listed companies in the EU (FSA's Chief Executive).
- CEIOPS[64] Solvency II Pillar 1 Expert Group (FSA Head of Department).
- CEBS[65] Expert Group Capital Requirements Directive (FSA Managing Director – until mid-2006).

3.11 Other FSA staff sit on or chair a range of expert and technical working groups. The FSA also has a number of secondees at the Commission and in the secretariats of the committees. Each year the FSA devotes a significant level of resources: some 38 person years on EU directive negotiations and a further 24 person years on the committees.[66] Included in these figures are 120 days of director level and above resource and the Chairman alone spent 42 days out of the country on EU and international business in 2006.

3.12 In addition, since January 2005 the FSA has produced a regular publication – *International Regulatory Outlook* – to inform and update industry on European and international issues, and, in particular, to highlight the extent to which new regulatory requirements arising from international initiatives, particularly European Union legislation, are likely to have an impact on consumers, markets and regulated firms.

The FSA's objectives for EU influencing and representation

3.13 The FSA does not have a formal statutory objective in relation to EU influencing. It does not view its role as creating or protecting UK 'national champions', nor as a national advocate seeking to direct the EU debate. The FSA's aim for its European work is to ensure that regulation is proportionate, consistent with a principles-based approach and assists in achieving FSA objectives. The FSA seeks to achieve these objectives in four main ways:

- Early engagement on specific measures.
- Supporting a properly functioning European regulatory architecture.
- Promoting and facilitating the use of Better Regulation methodologies.
- Encouraging a more principles-based approach.

Early engagement

3.14 The FSA monitors potential and forthcoming proposals and attempts to understand early their purpose and implication for the UK. It agrees an approach with HM Treasury (which remains the principal negotiator of EU measures) ahead of negotiations and highlights strategic issues for the UK. It may provide suggestions on wording or scope for draft proposals. It collaborates with the other regulators on Lamfalussy committees and tries to influence the advice provided in response to requests from the Commission. It also offers technical advice to MEPs, although it views lobbying of non-UK MEPs as the role of the UK's Permanent Representative and HM Treasury. Appendix 3b illustrates the FSA's and HM Treasury's roles and methods of influencing at each stage of the EU policy-making process.

Supporting the European regulatory architecture

3.15 The FSA is committed to making the existing regulatory structures in the EU work well. Its preferred approach to the future of financial services regulation is based around effective collaboration of national regulators using the Lamfalussy structure. It has four objectives for making EU decision-making structures work better:

- Progressing arrangements for enhanced supervisory cooperation (including promoting home/host co-operation with other EU regulators).[67]
- Encouraging greater co-ordination between the Lamfalussy committees on cross-cutting issues.[68]
- Greater use of peer group review to ensure effective implementation of measures, including monitoring to check that implementation is consistent with the directives.
- Embed the use of impact assessments in the work of the Lamfalussy committees.

Better Regulation

3.16 The FSA has actively promoted Better Regulation in the EU, both in the Commission and in the Lamfalussy committees. In December 2005 the Commission's White Paper[69] committed to:

- open and timely consultation;[70]
- greater use of impact assessments;
- consideration of alternatives to legislative proposals (such as greater use of competition powers, or industry codes); and
- ex-post evaluation of regulations.

As part of its Better Regulation drive, the FSA has also taken a clear stance on some potential European policies. For example, in its latest *International Regulatory Outlook* report, it argued that Europe-wide regulation of mortgages did not seem necessary because there was not at this stage any clear-cut evidence of a market failure in national mortgage markets across Europe.

A more principles-based approach

3.17 The FSA is advocating the greater use of principles as a way of delivering more proportionate regulation in the EU. It recognises that, despite the widespread endorsement of Better Regulation, it may take some time before there is a decisive shift to more principles-based regulation in the EU. Commission staff, like those in many firms and regulators, understand rules and are comfortable with them. Legal and cultural traditions vary widely among Member States and in some cases there are legal impediments to adopting a more principles-based approach.[71] In addition, there is a potential risk that the principles in the directives will not necessarily align with the FSA's own principles.

FSA's performance in Europe

3.18 London is the most prominent European financial centre. More international banks are based in London than elsewhere, and more financial transactions are conducted in London, both on an off the main exchanges such as the Stock Exchange, than elsewhere. In addition, a recent high-profile report by McKinsey & Company[72] found that London's relative position as a financial centre had improved in particular compared with New York in the last three years, and a report published by the City of London Corporation in November 2005 highlighted that London and New York had in the last few years moved further ahead of Frankfurt and Paris as international financial centres.[73] These reports identified the FSA's regulatory regime as a significant factor in relation to the emergence of London as the most prominent European financial centre. It is difficult to disentangle the FSA's contributions to these developments from the contribution of others, such as the City of London Corporation, which has been very active, including opening its own office in Brussels and coordinating the input of UK trade associations into strategic European decision-making processes.

3.19 Stakeholders generally consider that the FSA does reasonably well in what is a complex and difficult environment, in particular at engaging early with the Commission to influence early thinking and draft proposals. In the Financial Services Practitioner Panel survey, a majority of respondents felt that the FSA was "alert to emerging EU issues and prepares its position in time". However, slightly more disagreed than agreed that "the FSA is suitably co-ordinated with HM Treasury" on EU and international issues. Roughly a third of respondents did not have an opinion. The Panel considered that the FSA's work in the EU and international arenas is of high technical quality and might merit being promoted more effectively to the industry at large.[74]

3.20 This may indicate that the FSA should enhance its communications with industry by explaining more clearly to the industry what the FSA wants to achieve in Europe, the context of EU negotiations, the level of commitment of senior FSA staff, the interaction between FSA and HM Treasury, and periodically demonstrating, in a published report, how far it has met its objectives. An enhanced *International Regulatory Outlook* report may be one way for communicating these messages. Achieving this may require clarification of the balance of responsibility between the FSA and HM Treasury for communicating high level messages on European issues to industry.

3.21 Members of the committees of national regulators that we interviewed also commented positively on the FSA's participation, in particular that of the FSA's senior management. They perceived the FSA as being influential and respected, and a leader in terms of regulation of wholesale markets in the EU. Stakeholders, including the Financial Services Consumer Panel, commented favourably on the level of consultation by the FSA with industry and consumer interests, especially in comparison with the more limited efforts at consultation by other Member State regulators.[75] As **Figure 12** shows, the FSA was instrumental in promoting a non-legislative solution on how to regulate credit rating agencies, when several other countries favoured a more traditional form of regulation by directive.

3.22 The UK has a good record in terms of implementing financial services directives on time and the FSA considers it brings advantages:

- It can give the FSA the opportunity to influence the way other Member States implement the directive.
- It avoids the risk of the Commission taking infraction proceedings against the UK.
- It can provide a competitive advantage to UK firms over European rivals whose governments implement the directive behind schedule.

Future issues

3.23 Since the Commission first embarked on the Financial Services Action Plan in 2000, there has been a major shift in thinking about regulatory approaches. The Commission has made a commitment to greater use of impact assessments and to subject all existing measures to post-implementation review. There are now therefore more explicit opportunities for the FSA systematically to influence the development of European policies at an early stage, and it should ensure that it does. For example, now the Commission has made a commitment to produce impact assessments supporting all new legislative proposals, the FSA can subject these to scrutiny.

12 Case study – credit rating agencies

In 2004 the FSA identified a growing issue of whether or not credit rating agencies were a potential source of market failure and therefore how they should be regulated. The FSA favoured a non-legislative solution and considered one was feasible. It promoted this in the EU and internationally through IOSCO. The FSA found that they were relatively isolated in Europe at first, as most other countries were minded to support the formal regulation of credit rating agencies. In July 2004, the Committee of European Securities Regulators (CESR) was asked by the Commission to provide technical advice on this issue. The FSA participated in the CESR Task Force set up to respond to this request for advice. During this period, the FSA also played an active role in the work of IOSCO which culminated in a Code of Conduct for credit rating agencies, which encouraged agencies to state publicly whether they complied with the Code or if not to explain why (known as a "comply or explain" model of enforcement). The CESR work resulted in a consultation paper in late 2004, which set out a variety of options, the vast majority of responses from all parts of the market argued in favour of there being no EU regulatory intervention at that time, given the recent introduction of the IOSCO Code and other relevant factors. The FSA was influential in persuading CESR to advise the Commission to adopt a "wait and see" approach. In January 2006 the Commission announced that it agreed with CESR's approach and that no new legislative initiative was needed, but that the situation would continue to be monitored. Under the agreed approach, credit rating agencies will send an annual report to CESR on their compliance with the IOSCO Code, and meet members of the Task Force to discuss their report, and report any significant incidents to CESR. CESR is also required to report back to the Commission annually.

Source: National Audit Office

3.24 There is still some way to go on the practical application of Better Regulation by the Commission and the Lamfalussy committees.[76] The FSA considers that it is not yet clear that the commitment to Better Regulation has permeated all levels of the Commission, nor the extent to which there will be the necessary commitment in the EU policy-making process to allow the time and resources to be devoted to these disciplines in future. In particular, whilst the FSA has welcomed the Commission's recent impact assessments, it considers that the Commission needs to improve the quality of the assessments and allow sufficient time for them to be carried out at key stages and to be consulted on.[77] The FSA has provided the Commission with technical advice and support to strengthen the approach for impact assessments.

3.25 There are issues that may undermine the effectiveness of the current Lamfalussy arrangements to secure greater convergence of national regulatory approaches:

- There is an on-going risk that EU supervisory convergence is not successful because the Lamfalussy structures become increasingly hard to operate. The Committees may also become too cumbersome or because the will to achieve meaningful regulatory convergence does not really exist (for example if the mediation mechanism for resolving significant differences of approach were not to be effective).
- Regulatory convergence is also made more problematic if Member States do not meet the agreed deadlines for transposition of Community law. The Commission considers that the rate of transposition by Member States is weak, and as a result companies cannot benefit fully from pan-European access.[78]
- The Davidson Review[79] reported that differential implementation across Member States matters more to businesses that operate across Europe than whether there is over-implementation of directives.

The FSA is committed to making the Lamfalussy arrangements work. The FSA is working to get its message across, particularly as the EU's Inter Institutional Monitoring Group is currently exploring the effectiveness of the Lamfalussy approach and will report later in 2007.

3.26 In the EU the optimal structure of financial regulation in Europe has become a subject of debate[80], particularly among Government and Commission officials, regulators and the leaders of major financial enterprises with operations across Europe.[81] The FSA and HM Treasury support the existing Lamfalussy arrangements as do other influential UK commentators.[82] However there are alternatives to the existing structures, including a single EU rule book,[83] a lead supervisor for cross-border financial institutions,[84] or the so-called single EU regulator (i.e. a European FSA).[85] Over the next few years, there may be growing pressure for radical reform of the regulatory structure for financial services. The FSA prefers to avoid entering into a debate on alternatives to the existing structures particularly given the speculative nature of the proposals. Some stakeholders we interviewed suggested that the FSA, as the regulator representing the largest financial services market in Europe, should adopt a higher public profile in promoting its vision for the future of European financial services regulation.

3.27 The scale and importance of the future issues facing the FSA in Europe suggest that the staff time devoted by FSA's senior management should at least be maintained or possibly enhanced, so as not to diminish the FSA's capacity to influence and achieve beneficial outcomes for the UK in Europe.

Influencing at the international level

3.28 Global institutions are important channels for arriving at a common understanding of issues and developing sound practice. The FSA estimates that they devote around 21 person years in total to the work of global fora including:

- the Basel Committee on Banking Supervision;
- the International Organisation of Securities Commissions (IOSCO);
- the International Association of Insurance Supervisors;
- the Financial Action Task Force; and
- the Joint Forum and the Financial Stability Forum (FSF).

3.29 The fora are important as they set global standards and develop policy at an early stage, which in some cases can subsequently lead to or influence EU measures. For example, the EU Capital Requirements Directive recasts existing directives to incorporate a revised capital adequacy framework (Basel II). The FSA played a leading role within the Basel Committee on capital adequacy. The FSA's objectives are to ensure that these institutions are focussing on the right issues; have focussed agendas and do not duplicate effort.

3.30 The National Audit Office interviewed a number of other overseas financial services regulators (primarily in the securities field). The common view was that the FSA is one of the leading regulators in their field:

- **International engagement:** The FSA is highly respected and influential in the IOSCO and FSF forums and resources its international work well. The FSA's staff are considered to be high-quality and they bring an intellectual weight to the discussions of these international bodies. As the regulator of a leading international financial centre, the FSA is a strong advocate of international co-operation and chairs a highly influential sub-committee of IOSCO in this area.

- **Role model:** The FSA is regarded as a leading advocate and role model in terms of risk-based regulation, and in bringing about a Better Regulation focus on the costs, burdens and benefits of regulation. Regulators welcomed the FSA's willingness to explain to them their regulatory approach in a constructive way.
- **Thought-leadership:** The FSA was considered strong at identifying emerging issues ("horizon scanning"), conducting high quality evidence-based research and tabling it for discussion at international fora. Examples included FSA's research on credit derivatives **(Figure 13)**, hedge funds, private equity, and financial reporting standards.
- The UK's arrangements for **financial stability** (a tri-partite arrangement between the FSA, HM Treasury and the Bank of England), were considered to provide models of good practice that other countries could use to inform their own arrangements.

3.31 An on-going issue for the FSA is how far to harmonise and standardise with other financial regulators, in particular those of the US and other leading international financial centres. A global association of leading financial institutions has called for a strategic dialogue on effective and efficient regulation, and prioritising global coordination as an essential part of any jurisdiction's regulatory process.[86] The recent report by McKinsey & Company (paragraph 3.18) noted that there was a trend toward US-headquartered firms shifting leadership of certain corporate and investment banking businesses from New York to London, as well as a number of other big US firms shifting high-level decision-makers to London.[87] The Report drew attention to the perceived superiority of the UK's regulatory environment, including the UK having a single integrated financial regulator, and a more principles-based approach. In addition to this report, there have been other calls in the US for changes to its regulatory environment.[88] These calls for the US to review its regulatory approach may provide further opportunities for the FSA to work with its US regulatory counterparts on harmonisation of approaches and to work in a coordinated manner, for example on broking commissions (so-called "soft dollar" rules); rulebooks for broking activities; and financial reporting software standards.

3.32 The City of London Corporation noted in its November 2005 report that "if there is to be a third global financial centre (after New York and London) it is likely to come from one of four or five potential candidates in Asia, not from Europe."[89] With the emergence of Asia-Pacific markets, there may be opportunities for the FSA to seek to harmonise approaches and rules with the regulatory authorities in these markets.

13 Case study: credit derivatives and bilateral working between FSA and other regulators

The credit derivatives market has grown exponentially from $3¾ trillion in 2003 to $26 trillion in 2006. Currently more than 80 per cent of the volume of the credit derivatives market is in London and New York, with the majority in London. This rapid growth resulted in a backlog as back office functions could not keep pace with trading activity. In April 2004, the FSA became aware for the first time of a backlog at a meeting with a leading investment bank. The bank decided to shut down this side of their business until the backlog was reduced. Consulting more widely, the FSA found similar problems in other market participants.

The FSA encouraged the Joint Forum[1] (chaired by the FSA at the time) to look into the credit derivatives market to identify risks and to make recommendations regarding their possible mitigation. The result was an authoritative study on the credit derivatives market which contained recommendations for the public and private sector and attracted widespread market interest. The FSA hosted an industry roundtable in December 2004 to discuss the study's findings. Subsequently the FSA wrote a 'Dear CEO' letter to the heads of UK regulated firms in February 2005 which indicated that the FSA was concerned about the backlog.

The FSA alerted other international regulators such as the United States Federal Reserve and the German financial regulator (BAFIN). The Federal Reserve organised a meeting in September 2005 which included the US, German, Swiss, and UK regulators and industry members. It identified concerns about the backlog and concluded that if industry was not prepared to tackle it, the regulators would come up with a severe regulatory solution. At the meeting, the FSA presented figures to demonstrate the seriousness of the problem. The industry was asked to put forward a suggested solution. This involved market participants producing monthly figures for the regulators. The FSA and the other regulators agreed to meet every six months to monitor the market and to ensure the backlog was under control. A survey[2] in July 2006 showed substantial progress had been made by the industry.

Source: National Audit Office

NOTES

1 Joint Forum: a cross-sectoral group made up of the Basel Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors.

2 The Credit Derivatives Backlog Joint Survey.

PART FOUR

Financial Crime

To achieve progress in combating financial crime, a regulator needs to establish a coherent organisational approach which is integrated across, and makes the most of, all of its regulatory functions. It also has to achieve close cooperation with its partner organisations and with industry.

This section of the report shows:

- **resources applied to combating financial crime (including counter-terrorist finance)**

  The FSA devotes under 10 per cent of its resources to its financial crime objective. The FSA could improve the effectiveness with which it uses the current level of resources and does not need to increase significantly the total amount of resource in the short term. It could also consider the weight it gives to financial crime risks within its risk assessments (paragraphs 4.5 to 4.25).

- **integrating the FSA's work on financial crime with its other supervisory work**

  The FSA has given greater emphasis to financial crime within its internal structure in recent months, consolidating three functions into a new Financial Crime Division. It did so to address concerns that financial crime issues had insufficient weight in the FSA's day-to-day supervision of financial institutions and its risk assessments (paragraphs 4.26 to 4.34).

- **the integration of the FSA's work on combating financial crime (including counter-terrorist finance) with other agencies in this field**

  The FSA has recorded some important achievements in working with other UK agencies responsible for financial crime reduction in the UK. In particular it has acted as a catalyst to lead a wide range of organisations to adopt a common approach to financial crime issues (paragraphs 4.35 to 4.44).

- **the FSA's communication and information sharing with business about financial crime**

  The FSA has increasingly encouraged financial institutions to adopt a risk-based approach, particularly in respect of their money laundering controls, so that institutions do not impose unnecessary identity checks on low risk consumers. The FSA's new approach has been widely applauded by financial institutions (paragraphs 4.45 to 4.51).

- **the FSA's use of its enforcement powers and penalties**

  The FSA adopts a proportionate approach to using its enforcement powers on financial crime. It seeks to use criminal prosecutions and significant civil fines only for serious wrongdoing and uses a clear process of escalation to reflect the seriousness of the case. Business leaders increasingly perceive the FSA's approach as more effective than an alternative, more punitive approach, such as that taken by US regulators. (paragraphs 4.52 to 4.66).

Introduction

4.1 Under the Financial Services and Markets Act 2000 (the Act), the FSA must work to "reduce the extent to which it is possible for a [regulated] business… to be used for a purpose connected with financial crime".[90] The Act defines financial crime as including:

- fraud or dishonesty;
- market abuse (misconduct in, or misuse of information relating to, a financial market, which can be prosecuted under either a civil or criminal regime); or
- handling the proceeds of crime (or money laundering).

4.2 The FSA is the lead UK authority on market abuse and supports others on anti-money laundering[91] (HM Treasury is the lead authority) and fraud (no national lead has been established).

4.3 Financial crime covers a very disparate, and evolving, set of criminal activities. It includes fraud against individuals or financial institutions, laundering the proceeds of crime through a financial institution, financing of terrorist activity through a financial institution, misuse of confidential market information (often known as insider dealing), as well as misconduct relating to markets, whether that is manipulating transactions, distorting markets or misleading behaviour that could affect the value of an investment. Financial crime also has an increasingly international dimension with the growth of cross-border criminal activity.

4.4 As a result, the FSA's work on financial crime covers a variety of circumstances, including:

- a regulated firm is unknowingly used by a third party as a conduit for financial crime (e.g. money laundering, market abuse or fraud against the firm's customers);
- a regulated firm is the victim of financial crime (e.g. fraud against an insurance firm);
- a regulated firm or person commits financial crime (e.g. market abuse); and
- a third party, that is not regulated by the FSA, commits market abuse.

In each case, the FSA is interested in the systems and controls that regulated firms have in place to prevent, detect and report any of these instances.

Allocation of resources to financial crime

4.5 Developing a coherent organisational approach to financial crime requires the FSA to:

- gain an understanding of the nature and scale of the problem, by developing estimates of crime types where possible;
- define what it aims to achieve, and develop a strategic approach which includes goals or targets and an approach to monitoring progress; and
- identify and allocate resources to the areas of highest risk.

Estimating the scale of financial crime

4.6 The FSA produced a Financial Crime Strategy in May 2006. This strategy sought to gain a better understanding of the scale and incidence of financial crime, and the impact on the UK and financial institutions.

4.7 There are inherent difficulties in producing any macroeconomic estimates of fraud, money laundering and market abuse. Research techniques used in other areas (such as surveys or gathering data from firms) are often not possible or unlikely to produce realistic data for levels of financial crime.[92] Compared to other areas of its work, such as Financial Capability (Part 5), the FSA has taken longer to start the process of measuring and quantifying the extent of financial crime. This delay is in part due to the FSA having to rely on a network of partners for information about crime, or to produce estimates on which they can base their own analysis.

4.8 There are now several streams of activity to estimate the scale of financial crime:

- **work by the Home Office on the proceeds of crime –** the Home Office is due to publish its analysis of turnover of the organised criminal economy in the UK. This figure, based on conservative estimates of revenue for the major organised crime type such as drugs or people smuggling, totalled more than £11 billion a year and additional research suggested it may be at least £15 billion. Separately, the *Financial Challenge to Crime and Terrorism* speculates that about £10 billion is laundered through the regulated sector annually.[93]
- **other external research –** there has also been other research and analysis in the academic and private sectors on the nature and scale of financial crime. For example, PriceWaterhouseCoopers conducts a biannual survey of firms to determine their experience of financial crime.[94] And the Association of Chief Police Officers commissioned the University of Cardiff to develop fraud estimates which conservatively estimated that fraud, excluding income tax and EU fraud, cost the UK £13.9 billion in 2005 and suggested the actual figure was likely to be a £20 billion annual loss to the UK through fraud.[95]
- **the FSA's approach –** in the absence of generally accepted estimates of the levels of financial crime, the FSA has commissioned its own research in three areas:
    - **market abuse:** looks at price and other distortions in the markets ('market cleanliness').[96] The 2007 report suggested that the measure of informed trading is higher than it was before the introduction of FSMA;[97]

- **fraud and money laundering:** aims to establish an agreed methodology for measurement; and
- **perceptions of financial crime:** asks firms and their Money Laundering Reporting Officers about their views on financial crime.

4.9 Until this current and planned research yields results, the FSA is not able to measure accurately its performance against its statutory objective relating to financial crime. This also means that the FSA continues to develop and implement its strategic response without a clear picture of the scale of financial crime.

Developing a strategic response

4.10 The Financial Crime strategy produced in May 2006 explained the FSA's planned approach to combating money laundering, terrorist financing and fraud. It did not cover market abuse, which remained the separate responsibility of the FSA's Enforcement Division and the Market Monitoring Department. The strategy outlined how the FSA aims to focus supervisory work on poor performing sectors or groups of firms, as well as to influence international standards for reviewing money laundering controls.

4.11 To date, the FSA has focused mostly on tackling money laundering. Its response on fraud is under development, after the publication of the government's Fraud Review in July 2006, which recommended the establishment of a dedicated National Fraud Strategic Authority. Its work on terrorist financing is also still evolving. It aims to bring together industry, government and law enforcement agencies to develop a common understanding of how to combat the problem. But the sums of money involved are often too small for financial services institutions to detect with their current systems before an issue arises.

4.12 The FSA's strategic approach has been influenced by:

- **the rapidly changing nature of financial crime: Figure 14** shows three important areas of change that have affected the FSA's work to date;
- **placing reliance on industry:** the FSA believes that there are greater commercial incentives for firms to invest in systems to counter fraud than money laundering. It has therefore relied on the private sector to develop its response to fraud, while it has placed greater emphasis on money laundering.

4.13 The FSA has developed both a high-level and a day-to-day approach to measuring and monitoring progress in its financial crime work. The high level approach is incorporated into the FSA's new, organisation-wide performance system, called the Outcomes Performance Report (the Outcomes report is covered in detail in Part 1 of this report). This groups a variety of indicators and measures that relate to the financial crime objective, including: authorisations rejected by the FSA; consumer enquiries to the FSA; financial crime cases referred to Enforcement; measures of 'market cleanliness'; and number of Suspicious Activity Reports submitted by regulated firms (Appendix 4b shows the relevant measures in the Framework for financial crime).

14 Changes in the financial crime landscape

Change	Issue
Public Interest	■ The profile of counter terrorist finance has risen dramatically in the UK since the July 2005 terrorist attacks in London. Developing a response to this issue, in addition to ongoing money laundering requirements, now occupies a significant amount of effort.
Jurisdiction	■ Firms from newer European accession countries, such as Romania and Bulgaria, can be 'passported'[1] into the UK. This may alter the nature of the risks that some regulated firms pose in respect of financial crime.
Technological	■ The widespread introduction of 'Chip and PIN' technology to bank cards has led to fraud being displaced to other methods. ■ Firms' information security systems and controls are increasingly susceptible to attack (particularly for customer details).

Source: National Audit Office

NOTE

1 Any EU firm which wishes to carry on business in another European Economic Area State may do so if it is within the scope of a relevant EU Single Market Directive. The exercise of this right is known as 'passporting'.

4.14 On day-to-day progress, for example, staff training was a prime area of focus for the Financial Crime Sector team in 2006-07. Recently, the FSA has also developed a database for recording significant frauds reported by firms to FSA supervisors (since early 2006, this shows nearly £40 million in actual losses and £245 million in potential losses).

4.15 The 18 financial crime metrics in the Outcomes report and its other operational indicators will help the FSA to monitor its financial crime activity. It will have to review the Outcomes report to ensure that the metrics are meaningful. At a higher level, however, the FSA has not clearly defined what it aims to achieve from its financial crime work. Without some view of its target outcomes, these measurement efforts will not provide performance information to monitor progress or to inform future planning.

Identifying, and allocating supervisory resources to, financial crime risk

4.16 The FSA's allocation of resources is based on which firms or issues pose the greatest risk to its objectives. In supervising firms, the FSA calculates risk based on the impact and probability of an event taking place. Larger firms tend to take up more of its resources, because any event that occurs in a larger firm will have a wider effect on financial markets and consumers than a similar event in a smaller firm. The FSA also uses its risk dashboard to identify, rank and develop responses to market or non-firm specific risks.[98]

4.17 Assessing risk to the FSA's financial crime statutory objective is problematic because of the impact of financial crime on society in general. If criminals are able to launder the proceeds of crime through a financial institution, or access finance to fund terrorist activity, the negative consequences for society are greater than the direct financial disadvantages for the institution or market. Criminal or terrorist activity with very negative outcomes for society in general could stem from large or small sums of money, and the transaction could take place in large or small firms. In terms of risk assessment, this means the size of a firm provides a weaker proxy for impact. There is debate about the extent to which the wider impact of financial crime on society should be considered as part of the FSA's statutory objective.

4.18 The FSA's assessment of the 'probability' of a risk crystallising is also very important in the area of financial crime. Smaller firms are less likely to have staff dedicated to compliance and may have fewer staff focusing on internal anti-crime systems and controls. Under new regulations, firms are increasingly able to rely on other firms' anti-money laundering controls in chains of transactions,[99] so the importance of small firms in the anti-money laundering system increases.

4.19 The FSA deploys resources directly and indirectly across the organisation to address risk to its financial crime objective. The teams working directly on financial crime include the Financial Crime Sector Team, the Financial Crime Policy Unit and the Intelligence Department (all now part of the Financial Crime and Intelligence Division), plus a proportion of the Market Monitoring Department and the Enforcement Division.

4.20 Just as important are the indirect resources that the FSA deploys in its supervision of firms, although financial crime is just one aspect of the supervisory process. To deal with its large regulated population, the FSA has had to differentiate the level of scrutiny of financial crime issues applied to different sized firms **(Figure 15)**.[100] Larger firms receive targeted and regular scrutiny from their supervisors. Over 20,000 smaller firms are reviewed through a computerised checking system of firms' self assessment reports. At present, there are no financial crime-related checks amongst the 24 checks[101] the FSA carries out on the reported information. But it does carry out adhoc reviews to examine closely anti-crime awareness and standards among the small firm population.[102]

15 Scrutiny of firms' financial crime controls by the FSA

Relationship managed firms (larger firms)

- Risk assessment of firm's controls (e.g. accepting customers) based on research and past knowledge of firm
- Visits to firm (interview senior management and money laundering reporting officer)
- Post-visit communication[1] to resolve issues
- Often selected for the FSA's thematic work

Medium-sized and smaller firms

- Firms submit reporting returns – these are processed with 24 'checks'
- Correspondence with firm to resolve problems
- Visits are very rare – but road shows and other targeted information are provided
- Firms sometimes selected for thematic work

Source: National Audit Office

NOTE

1 For the largest firms, there is an ongoing relationship with their supervisor, and communication may be daily.

4.21 The FSA's overall approach to risk assessment of firms may not capture all financial crime risks. Although it carries out additional review work based on new risks identified, the FSA's deployment of resources, based on a firm's aggregate risk level, is weighted heavily towards larger firms. To address this problem the FSA could increase its education efforts with small firms.

Monitoring the current level of resources allocated

4.22 The FSA cannot calculate precisely the resources it devotes to financial crime. This is because time spent on supervising firms, which forms a significant part of the financial crime effort, is not recorded by statutory objective. It is made more difficult because the FSA's time recording system reports only on time allocated, and not cost of that time (Part 1).

4.23 The National Audit Office has analysed the available data on resources spent by the FSA on financial crime. We have made conservative estimates of the full resource cost using two alternative methods, with details in **Figure 16**:

- Hours of work spent by FSA staff as a proportion of total staff time; and
- Proportion of total budget, based on estimated percentage of time spent.

4.24 Using staff time data, we calculated that just under 50,000 person days (or 220 person years) have been deployed across the FSA on financial crime. Based on average staff numbers for 2005-06, this means that about eight per cent of total FSA staff time was deployed in pursuing the financial crime objective. Using the FSA's budget estimates, we calculated that the total proportion of costs dedicated to financial crime work was £25 million, just under nine per cent of gross expenditure for 2005-06.[103] Until the FSA has developed its activity based costing to more accurately identify the resources devoted to financial crime it cannot determine whether this level of resourcing is necessarily sufficient.

4.25 The FSA may not need to increase the number of staff working directly on financial crime. Instead, it can integrate this work more effectively across the whole organisation, to ensure a suitable level of emphasis across all its regulatory functions.[104]

Integration with supervisory work

4.26 The FSA's supervisory staff have to balance a large number of competing priorities in their role. Effective integration of financial crime work into their day-to-day work relies on:

- financial crime issues having sufficient profile and weight; and
- staff developing adequate knowledge and expertise.

The profile of financial crime within the supervisory function

4.27 The FSA has four statutory objectives, and supervisors have to maintain a focus on issues such as prudential standards (e.g. credit, market, operational, insurance and liquidity risks), whether a firm is Treating Customers Fairly and the firm's business model and products.

4.28 Until the end of 2006, the FSA used an advocacy approach, with a small specialist team seeking to raise the profile of financial crime amongst supervisors and other staff across the FSA. Despite the efforts of this team when the National Audit Office survey of FSA supervisors asked about the regularity of their contact with the Sector Team three in every five respondents 'Rarely' or 'Never' had direct contact.

4.29 From 1 January 2007, the FSA has established a new Financial Crime and Intelligence Division within the Wholesale & Institutional Markets Business Unit. This should raise the profile of financial crime across the FSA. The Division will be more visible within the FSA's organisational structure, and by increasing the resource commitment (notably with an operations team to undertake more issue-based work), it signals the importance senior management attach to financial crime issues.[105]

4.30 These structural changes should also ensure that the organisation can derive benefits from housing all financial crime issues within a single Business Unit. For example, better linkages may be possible between the two arms of intelligence gathering and analysis: the Intelligence Team and the Market Monitoring Department. It will also encourage FSA staff to take a more cohesive view of financial crime, by including anti-money laundering, fraud and market abuse together in one business unit.

16 Resources applied to combating financial crime by the FSA

Area	Approximation of resources in 2005-06 in (a) time and (b) cost
FSA – Direct resource costs	
Financial Crime Sector Team (and network)	(a) 1,800 days per year (FSA estimate). (b) Part of the Regulatory Services Business Unit budget of £52 million. Assuming 1–2 per cent of this budget, and 100 per cent of time spent on financial crime, equates to an annual resource cost of around £0.8 million.
Policy & Intelligence Department	(a) 10,400 days per year (FSA estimate from i-Time recording system). (b) Part of the Regulatory Services Business Unit budget of £52 million. Assuming 3–4 per cent of this budget, and 100 per cent of time on financial crime, equates to around £1.8 million.
Enforcement Division	(a) 12,700 days per year (FSA estimate from i-Time recording system). (b) Divisional budget is £32.6 million and 25 per cent of time[1] is spent on financial crime. The annual resource cost is around £8 million.
Market Monitoring Department (and Markets Division)	(a) 3,500 days per year (FSA estimate). (b) Part of the Wholesale & Institutional Markets Business Unit budget of £66.9 million. Assuming 3–5 per cent of this budget, and 60 per cent of time, equates to around £1.5 million.
General Counsel Division	(a) 100 days per year (FSA estimate). (b) Part of the £32.9 million Corporate Services budget. Assuming 7–8 per cent of this budget, and one per cent of time, equates to around £0.03 million.
Direct resources spent: approx 28,500 days or in the range of £12 million (crude estimate)	
FSA – Indirect resource costs	
Supervision	(a) With the current systems, it is virtually impossible to gather any robust data about resources input to financial crime. A rough estimate is 10 per cent of total time, which is 15,000 days per year. (b) Core part of £96.3 million Retail Markets and £66.9 million Wholesale Markets budget. Assuming 75 per cent of these budgets, and 10 per cent of time spent on financial crime, equates to an annual resource cost of around £12 million.
Regulatory Transactions (e.g. Authorisations)	(a) Data is similarly poor, but a rough estimate of time is 4,400 days. (b) Part of the Regulatory Services Business Unit budget of £52 million. Assuming 15 per cent of this budget, and 10 per cent of time spent, equates to around £0.8 million.
Other areas	(a) Areas such as the Knowledge Management and Risk Review also contribute, but there is little data – between 200–500 days. (b) Assuming 1 per cent of Regulatory Services and Corporate Services budgets, and between 5–7 per cent of time, equates to around £0.8 million.
Indirect resources spent: approx 19,600 – 19,900 days or in the range of £13 million (crude estimate)	
External costs	
Firms	The FSA commissioned Real Assurance to estimate administrative costs to firms to comply with regulations.[2] Anti-money laundering rules equated to about 40 per cent of total costs, and over £250 million (e.g. customer identification, transaction records, and staff training).

Source: National Audit Office and FSA

NOTES

1 This estimate appears reasonable given that the National Audit Office analysis of enforcement cases shows that financial crime related cases make up between 12 to 20 per cent of cases opened. Given these cases are often complex and time consuming, they may take more effort proportionately than other cases.

2 http://www.fsa.gov.uk/pubs/other/Admin_Burdens_Report_20060621.pdf (p.5-6 and Annex 1).

Developing financial crime expertise

4.31 In 2005, the FSA recognised that it needed to provide its staff with better training and development on financial crime. It started by creating a computer-based training course for all staff to provide a basic level of knowledge. It then identified 593 staff who required more in-depth development. From mid-2006, the FSA delivered 21 intermediate training courses, reaching about 60 per cent of its target group (342 out of 593 staff). It also provided presentations on how staff should use the Joint Money Laundering Steering Group Guidance to industry, which reached 138 staff.

4.32 Given the importance of this training effort, we surveyed supervisors about their perceptions of financial crime. Two in five respondents had already attended the intermediate training course. Of these respondents, 70 per cent felt that they had 'Often' (14 per cent) or 'Sometimes' (56 per cent) been able to apply the training in day-to-day work. But under 40 per cent of respondents felt confident when reviewing a firm's financial crime prevention arrangements, as compared to 50 per cent for a firm's treatment of its customers, or 70 to 80 per cent for the interactions with the firm's compliance staff and senior management.

4.33 Qualitative responses to the National Audit Office survey highlighted concerns about their work on three areas (see Appendix 4c for detailed comments):

- The profile of financial crime issues within the organisation is not high enough.
- Supervisors are not sufficiently encouraged to focus on financial crime issues.
- Training needs to be more practical and better tailored to sector or firm size.

4.34 The FSA should make use of the increased profile of the new Financial Crime and Intelligence Division to assist staff in developing their expertise in financial crime issues.

Working with the anti-crime community

4.35 The FSA is required by the Act to "take such steps as it considers appropriate to cooperate with other persons…in relation to the prevention or detection of financial crime" including the sharing of information.[106] Effective joint working and cooperation on financial crime is based on:

- developing strong relationships and taking a leadership role where appropriate;
- cooperation based on the powers, roles and skills sets of each organisation; and
- open sharing of information.

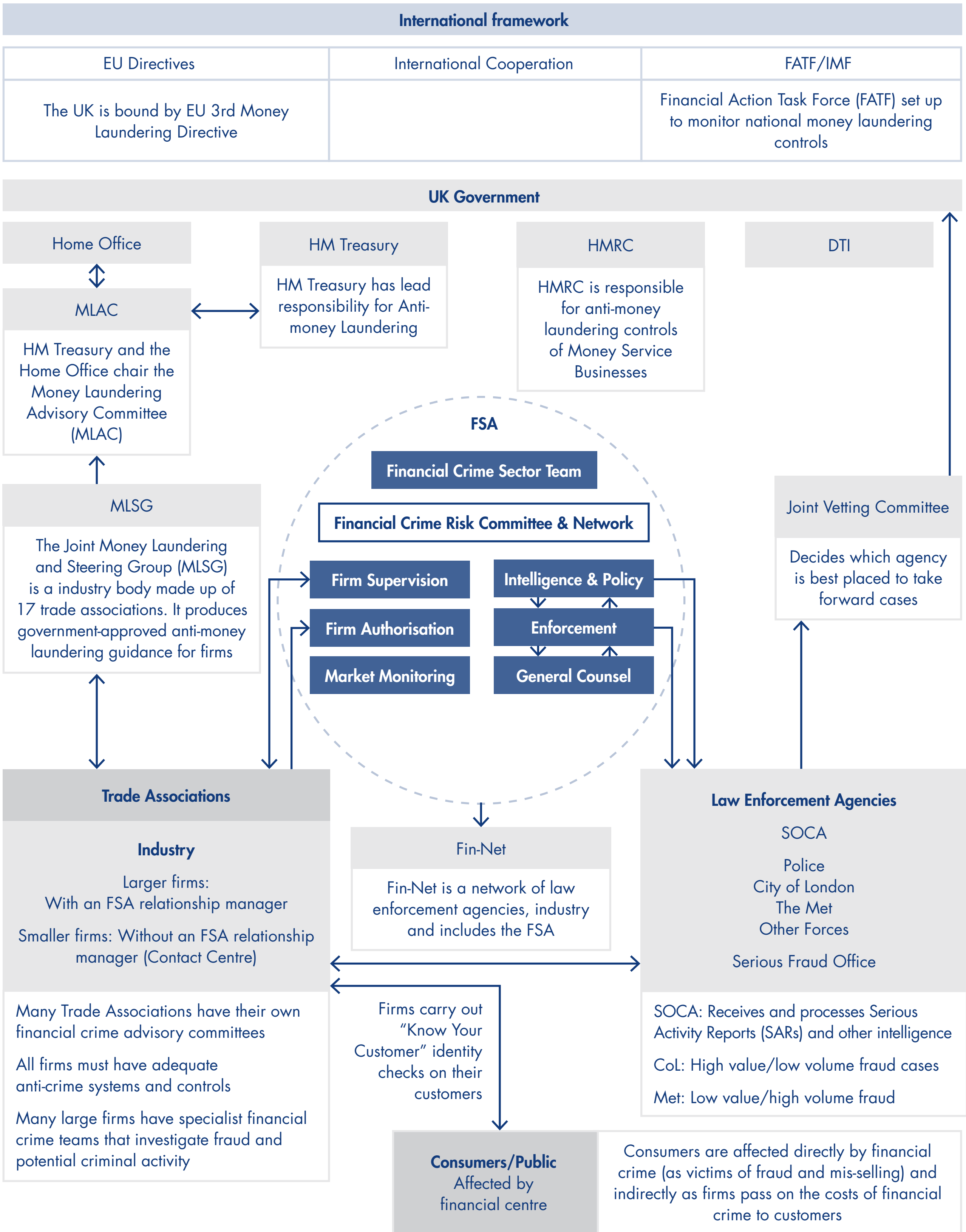
Developing strong relationships and taking a leadership role

4.36 **Figure 17** sets out the relationships between the FSA and its external partner organisations. These organisations are:

- the Police
  - the City of London Police (Economic Crime Department);
  - the Metropolitan Police Service (Economic and Specialist Crime Command); and
  - other regional police forces.
- Serious and Organised Crime Agency (Proceeds of Crime Department)
- Serious Fraud Office
- HM Treasury (Financial Crime team within Financial Services Division)
- Home Office (Organised and Financial Crime Department)
- HM Revenue & Customs (Anti-Money Laundering Unit & Criminal Investigations)

4.37 The FSA, led by its Financial Crime Sector Team, has developed strong relationships with each organisation and facilitated law enforcement networks with industry. It has acted as a catalyst to bring together all the relevant parties. In discussions with National Audit Office, both law enforcement agencies and industry praised the role played by the FSA in developing a cohesive and effective financial crime community. It has pressed for a single cross-government strategy on money laundering (launched by HM Treasury in October 2004) and now fraud (launched by the Attorney General's office in July 2006[107]). The FSA is now addressing other issues that require a coherent approach, such as terrorist financing. It also seeks to stimulate debate on upcoming issues, such as information security.[108]

17 The FSA's relationships with external bodies



Source: National Audit Office

NOTE

This figure shows the range of relationships between the FSA and other bodies on financial crime. The Serious Fraud Office is a government department.

Joint working and cooperation

4.38 The FSA cooperates on a day-to-day basis with law enforcement agencies on investigations, cases and other issues. The National Audit Office held interviews with its primary partners, to determine the level of joint working and cooperation. All of the law enforcement partners interviewed were largely positive about their working relationship with the FSA, particularly the Financial Crime Sector Team and the Enforcement Division. Figure 17 outlines the nature and scale of these working relationships.

4.39 Some of the partners interviewed felt that law enforcement activity could make more effective use of the FSA supervisors' in depth knowledge of the financial service industry. They also noted the inherent tension between the enforcement role of the FSA (in terms of firms' anti-crime controls) and the objective of encouraging firms to be open with the law enforcement community and report suspicions. **Figure 18 on pages 45 and 46** summarises our interviews.

Working with international regulators

4.40 Financial crime, particularly money laundering and terrorist financing, is not contained within national borders. The FSA works with a wide range of international organisations and regulatory counterparts in other countries to combat financial crime.

4.41 The FSA works particularly closely with the Financial Action Task Force (FATF), an international body that carries out mutual evaluations of member[109] countries' anti-money laundering regimes and determines a 'rating' of compliance with its 49 recommendations.[110] The FSA plays a leading role within FATF, with one of its staff members working up to 90 per cent of the time with FATF on policy issues and training secondees to FATF in how to carry out evaluations (another four staff are now trained to carry out evaluations). It is also leading a FATF research project to produce guidance on how to implement a risk-based approach to managing money laundering risks.

4.42 The FSA also works closely with the International Organization of Securities Commissions (IOSCO). One of the four areas of focus for IOSCO is enforcement of securities law, and the FSA has ensured that important issues are being tackled by this group. Recent issues covered include engaging uncooperative jurisdictions and freezing or repatriation of proceeds of crime capital.

4.43 The Act requires the FSA to cooperate with, and investigate on behalf of, overseas regulators.[111] This cooperation ranges from responding to information requests (such as reviewing bank account details or identifying market trading data), to conducting interviews, providing testimony or carrying out parallel investigations.

4.44 Given the size of the financial services industries in the US and UK, one of the most active of the FSA's international relationships is with the US Securities and Exchange Commission. In its annual performance account, the Securities and Exchange Commission publishes the number of requests to and from foreign regulators for enforcement assistance.[112] It receives an average of 400 requests a year and makes about 350 requests. The FSA does not publish similar data. However, in our interview, the Chairman of the Securities and Exchange Commission told us that cooperation with the FSA accounts for a very significant proportion of this activity.

Working with industry

4.45 The FSA relies heavily on the cooperation of the financial services industry to support it in maintaining clean and orderly markets and in combating financial crime. Effective working with industry relies on:

- building cooperative relationships;
- proactive sharing of information; and
- providing feedback to industry.

Building cooperative relationships

4.46 Two important factors have influenced the FSA's relationships with firms in the area of financial crime. Firstly, there is an inherent tension in the FSA's role. Principle 11 of the FSA Handbook requires that "a firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice".[113] For example, the FSA would expect a firm to report any weakness in its own anti-money laundering or fraud controls. On the other hand, the FSA can sanction a firm for having inadequate anti-crime controls, and failure to have the requisite systems in place can also be a criminal offence under the Money Laundering Regulations 2003.[114]

18 Working relationships with the FSA

Partner	Nature of working relationship
Serious and Organised Crime Agency (SOCA) Proceeds of Crime Division	Role in financial services sector ■ Responsible for Suspicious Activity Report regime on money laundering and any money laundering prosecutions Relationship with Financial Services Authority ■ Strong relationship with regular communication ■ Personnel sharing (e.g. secondments), training and presentations ■ SOCA provides summary Suspicious Activity Report information to FSA. FSA feeds back information on the quality of reporting from the regulated sector Risks or potential areas for improvement in relationship ■ SOCA want to encourage reporting by firms, so it is cautious about the potential for FSA to use reporting information against firms ■ Potential for FSA supervisors to feed industry knowledge and expertise to SOCA
City of London Police Economic Crime Department	Role in financial services sector ■ Financial crime investigations, predominantly commercial fraud Relationship with Financial Services Authority ■ Strong relationship with increasing cooperation and some intelligence sharing ■ Main focus is support to FSA enforcement cases for searches, seizure, arrest, questioning, charging and bail (MoU signed in 2005)[1] ■ Shared training (e.g. search procedures, warrants and financial markets) Risks or potential areas for improvement in relationship ■ Receives no funding for support to FSA. May need to formalise relationship in future as City of London police cannot always guarantee assistance if there are other demands on resources.
The Metropolitan Police Service Economic & Specialist Crime Command	Role in financial services sector ■ Tends to focus on high volume, low value fraud, often working with industry on proactive prevention (e.g. frauds using Western Union) Relationship with Financial Services Authority ■ Fairly regular contact on broad issues Risks or potential areas for improvement in relationship ■ Some concern about the interplay between regulator and law enforcement in terms of incentives for firms to report – may require protocols in future ■ Current focus on money laundering may direct firms' resources away from fraud
Serious Fraud Office (SFO)	Role in financial services sector ■ Complex fraud cases Relationship with Financial Services Authority ■ Good relationship, mostly with the FSA's Enforcement Division ■ Both on Joint Vetting Committee which decides which agency will take upcoming cases ■ FSA refer cases to SFO and SFO request information from FSA. There are no joint cases ■ FSA support for Fin-Net (industry, law enforcement & regulator network) invaluable Risks or potential areas for improvement in relationship ■ Communication and information flows with supervisors sometimes difficult ■ Potential for conflict between regulatory and SFO investigations

18 Working relationships with the FSA *continued*

Partner	Nature of working relationship
HM Revenue & Customs	Role in financial services sector ■ Investigation of tax-related offences ■ Anti-money laundering supervision of money service businesses and high-value dealers Relationship with Financial Services Authority ■ Good relationship with both areas of HMRC, with open cooperation ■ Intelligence sharing, cooperation on approach to supervision, and policy liaison Risks or potential areas for improvement in relationship ■ Limitations to information sharing (e.g. taxpayer database) due to limits on legal gateways ■ Approach to money laundering supervision is more visit-based than that of FSA

Source: National Audit Office interviews with FSA and law enforcement agencies

NOTE

1 City of London and FSA had 4 major joint investigations in 2006 involving 10 searches, three arrests and substantial seizures.

4.47 Secondly, previous experience has influenced the reactions of firms to the FSA on financial crime **(Figure 19)**. The FSA has now developed a far more positive relationship with industry in terms of joint working on money laundering, particularly with the network of firms' Money Laundering Reporting Officers. It is important that the FSA ensures a similar cooperative approach is maintained if and when new, high-profile financial crime issues (such as terrorist finance) arise in the future.

Sharing information and providing feedback

4.48 The FSA relies on information provided by industry to identify potential areas of financial crime, and to maintain awareness of emerging issues. The two formal means of reporting are:

- **Suspicious Activity Reports (SARs)** – any knowledge or suspicion of money laundering/criminal proceeds must be reported immediately to the Serious Organised Crime Agency (Proceeds of Crime Act 2002 and Money Laundering Regulations 2003).
- **Suspicious Transaction Reports (STRs)** – firms must report transactions suspected of constituting market abuse to the FSA (EU Market Abuse Directive 2005).[115]

4.49 Although the FSA is not the lead agency for the **SARs** regime, the Serious Organised Crime Agency provides summary information to the FSA on the level and trends of SARs received from the financial services industry. Early findings from European Commission research into pan-European SARs regimes shows that reporting levels in the UK are much higher than in many other European countries, particularly from legal professionals. Reasons suggested for this difference include higher penalties for non-reporting in the UK and several high-profile enforcement actions. The FSA carried out a review of the **STR** regime in 2006. It received 266 reports in the first 15 months of operation and found that firms were generally complying with their reporting obligations.

4.50 In the new risk-based and more principles-based regulatory regime for money laundering/terrorist finance, firms have the freedom to determine their own solutions to the risks they face, rather than prescriptive rules from the FSA. The FSA has focused on providing information and assurances to industry, so that firms are not inhibited for fear of enforcement action by the FSA. For example, the Financial Crime Sector Team sent two published 'comfort' letters to firms via the Joint Money Laundering Steering Group, to emphasise the FSA's "commitment to supervising in ways that promote the risk-based approach".[116] The FSA's Markets Division has responded to requests from firms by producing a self assessment tool in November 2006, which suggests questions that a firm could run through. Further clarification has been provided by the FSA in speeches to industry; for example the FSA's Chief Executive's address to the Financial Crime Conference in January 2007 emphasised what the FSA expects of firms, focusing on the creation of a strong culture towards controls and effective scrutiny of financial crime risks and improved information sharing.[117]

4.51 Despite the positive relationships with industry and the wealth of information interchange, a number of firms and industry representatives told the National Audit Office that they would like more feedback and guidance from the

19 High profile anti-money laundering fines issued by FSA

In 2001, the FSA launched an investigation into the anti-money laundering controls at 23 banks in the UK with accounts linked to General Abacha, the former President of Nigeria.[1] At 15 of the banks, it found significant control weaknesses, which the FSA considered demonstrated that much of the sector had not adequately responded to the Money Laundering Regulations 1993. High profile fines were imposed on high street banks from 2002 to 2004 to sanction those with poor anti-money laundering controls.

Date	Firm	Fine (£ million)	Breach
17 Dec 2002	The Royal Bank of Scotland plc	£0.75m	Customer identification and record keeping
7 Aug 2003	Northern Bank	£1.25m	Customer identification
10 Dec 2003	Abbey National plc Abbey National Asset Managers	£2.0m £0.32m	Control weaknesses, reporting and customer identification
15 Jan 2004	Bank of Scotland plc	£1.25m	Customer identification records

There were, however, unintended consequences of this enforcement approach. Firms reacted to what they saw as a highly prescriptive approach from the FSA. Many banks implemented a 'tick-box' approach to complying with their money laundering obligations, particularly 'Know Your Customer' requirements.[2] Consumers bore the burden of this change, facing what they considered irritating requests for multiple items of identification on both new and existing basic accounts.

By 2004, the FSA saw that the industry was focusing unduly on the identification part of customer due diligence, and began efforts to communicate a change in emphasis to firms. This became known as "defusing the ID issue". The FSA brought together industry, government, law enforcement and consumer stakeholders to develop more realistic standards and pledged that enforcement action against a firm would be considered only if there was evidence of "particularly aggravating circumstances".

It worked with the Joint Money Laundering Steering Group to revise its industry guidance, which was formally endorsed by Treasury in February 2006. This coincided with FSA abolishing its detailed rules in the Money Laundering sourcebook and replacing them with high-level provisions for senior management controls. From September 2006, the UK money laundering regime was officially a risk-based regime. This means that senior management of firms have to understand their exposure to money laundering (and terrorist finance) and then decide how they establish and maintain requisite anti-crime systems and controls to address those risks.

Source: National Audit Office

NOTES

1 The FSA investigation identified 42 personal and corporate account relationships linked to Abacha family members and close associates in the UK. Turnover on the 42 accounts amounted to US$1.3 billion for the four years between 1996 and 2000 (http://www.fsa.gov.uk/pages/Library/Communication/PR/2001/029.shtml).

2 FSA Money Laundering Rules (no longer in existence), rule 3.1.3, "firm must take reasonable steps to find out who its client is by obtaining sufficient evidence of the identity of any client who comes into contact with the relevant firm to be able to show that the client is who he claims to be".

FSA on what the risk-based regime will mean in practice. Smaller firms particularly want more feedback, as they have less compliance infrastructure than larger firms to deal with new information. There may be scope to provide more practical guidance to firms in this transition period, such as peer benchmarking or worked examples.

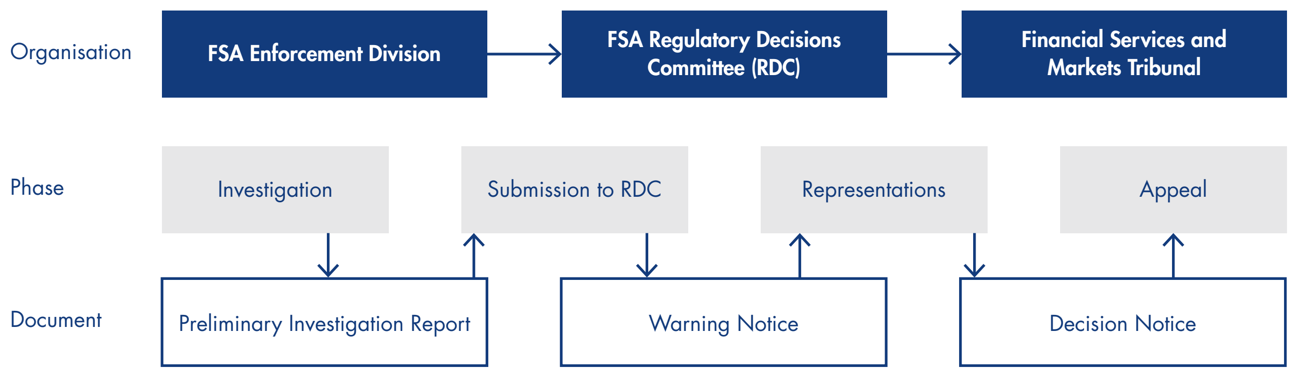
Using enforcement

4.52 The FSA's enforcement role supports the organisation's four statutory objectives. The terms of reference provided to the National Audit Office for this review, however, focus on enforcement only in relation to financial crime.

4.53 The Act gives the FSA power to investigate and take enforcement action against regulated firms ("authorised persons") and regulated individuals ("approved persons") for specific offences or rule breaches. It also has wider power to take action against other persons in instances of market abuse and breaches of listing rules.[118] The FSA can pursue criminal prosecution[119], civil process, or regulatory enforcement, depending on the nature of the problem. The penalties available range from public censure and withdrawal of a firm or individual's authorisation to financial penalties; and criminal sentences (**Figure 20 overleaf** shows the FSA's enforcement process).

4.54 Enforcement is one of a range of tools available to deal with non-compliant behaviour. Eight per cent of the FSA's total budget goes to the Enforcement Division, which has 270 staff. The FSA cannot and does not seek to pursue every potential case but aims to use it selectively in support of its priorities and strategic objectives. To achieve this aim it must identify and handle enforcement cases and set penalties in a proportionate way.

20 FSA enforcement process



Source: National Audit Office

4.55 The FSA's proportionate approach is reflected in the following key activities:

- integrated intelligence and detection;
- a strategic picture of enforcement priorities and a clear prioritisation process for selecting cases and powers to be used;
- adequate throughput of cases; and
- monitoring and self-review.

The intelligence gathering function

4.56 Intelligence is an important resource for any regulator, for example in assessing risk and where it has a law enforcement role. Information, often of a selective nature, has to be collected and reviewed systematically from both within and outside the organisation.

4.57 The FSA has two main areas that gather intelligence related to financial crime: an Intelligence team and a Market Monitoring team. Their different roles are outlined in **Figure 21**. In the past, the two areas have been separated but from 2007 both are within the Wholesale and Institutional Markets Business Unit.

4.58 The FSA reviewed both elements of its intelligence function during 2006 and produced an Intelligence Strategy in July 2006. There are four issues influencing the ongoing effectiveness of the FSA's intelligence-gathering function:

- Consistency of systems for handling intelligence – the FSA has now established a dedicated team to receive, log and distribute intelligence.
- Internal flow of intelligence and information – The National Audit Office survey of supervisors included questions about interacting with the intelligence gathering process. Although at least four out of every five respondents were Clear or Somewhat Clear as to which teams within the FSA they should pass sensitive information or intelligence, nearly half said they Rarely or Never pass on such information.
- Legal constraints to information sharing – in our discussions with the FSA and other law enforcement bodies, concerns were raised about legal restrictions on information sharing with government departments, for example HM Revenue & Customs.
- Investment in IT systems – the Intelligence team told the National Audit Office that there is a lack of connectivity between some intelligence systems. The FSA is, however, investing heavily in a significant upgrade to its transaction monitoring system. The current report storage system is being replaced by SABRE II, which will allow sophisticated analysis of market data and trading patterns.[120] The FSA has noted, however, in its analysis of MIFID that the increase in the number of independent trading platforms expected to enter the market could make it harder to monitor market abuse.[121]

Enforcement priorities

4.59 Each year the FSA determines its enforcement focus in terms of types of cases and sectors, which it describes in the annual report. The FSA has five enforcement priorities for 2006-07, one of which relates to financial crime (market abuse).[122]

21 Roles of the FSA's intelligence teams

Team	Role	Size
Intelligence (within Financial Crime and Intelligence Division)	■ Responsible for gathering intelligence from outside sources and across the FSA ■ Manages the 'SIS' database, used by other regulators and agencies in UK and beyond ■ Deals largely with law enforcement agencies, government and other regulators	33 staff
Market Monitoring (within Markets Division)	■ Responsible for monitoring transactions and reviewing transaction reporting from firms, for market abuse or manipulation[1] ■ Manages 'SABRE' market monitoring system[2] ■ Conducts initial review of intelligence, to screen for cases that require further action ■ Formal referral process with Enforcement Division ■ Deals predominantly with firms and FSA	40 staff

Source: National Audit Office

NOTES

1 There are often varied sources of intelligence for the different types of market abuse. An announcement-related price spike could trigger an Insider Dealing enquiry, a Misleading Statement will relate to an announcement or rumour in the market, and Market Manipulation will typically rely on tip-offs from the market about certain activity.

2 The FSA's bespoke securities and transactions database.

4.60 The FSA then has a case by case prioritisation process which is applied at the operational level. It uses 12 questions to assess the merits of prioritising any individual case. The FSA's case load is then reviewed regularly by a group of senior managers to ensure that its enforcement choices are suitable and being pursued appropriately in terms of:

- cases which are of significance in the priority areas;
- type of case (criminal prosecution, civil proceedings, or regulatory enforcement); and
- penalties and sanctions (public censure, variation or withdrawal of permission to carry out certain activities, financial penalties or criminal sentences).

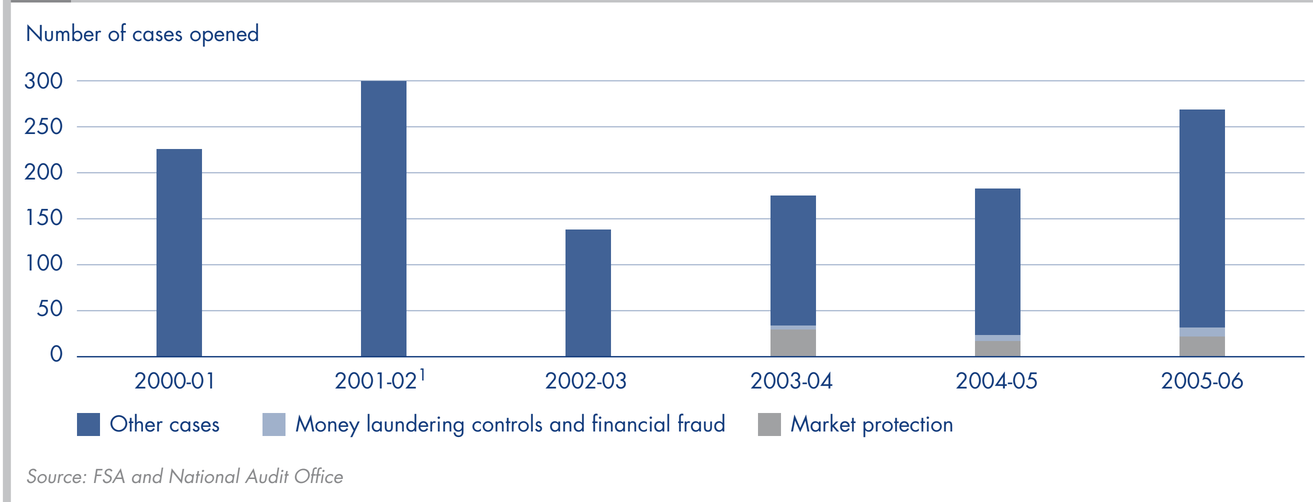
Case throughput

4.61 After a peak in 2001-02, when it took on the enforcement caseload of the self-regulatory organisations that merged to form the FSA, the FSA has opened an average of 200 cases each year. **Figure 22 overleaf** shows market protection[123], money laundering controls and financial fraud cases make up between 12 and 20 per cent of case opening volumes. This reflects the additional complexity and resources involved in these types of case. In 2005-06, out of a total of 269 cases opened, 22 cases related to market protection and 10 to money laundering controls and financial fraud.

4.62 Overall, the FSA converts approximately two in every five enforcement cases it opens into formal action against the firms or individuals involved and took formal action in 81 cases in 2005-06 against the firms or individuals involved. In 2005-06 the FSA closed 30 financial crime related enforcement cases. In 43 per cent of these cases there was no case or no further action was taken. Seventeen per cent resulted in a fine and 10 per cent in a conviction/sentence. Criminal cases require a significant investment of resources and involve longer timescales. The FSA is working to develop its criminal investigation capacity to enable it to pursue criminal as well as civil cases, for example by recruiting criminal lawyers, ex-police officers and other investigative specialists.

4.63 Financial penalties are not issued in all cases where the FSA takes action. In 2005-06, 17 cases involved financial penalties totalling £17.4 million, £14 million of which was for one market protection case and £505,000 related specifically to financial crime. Although market abuse and money laundering cases account for only a small proportion of total enforcement cases they generally account for a relatively high percentage of the total financial penalties issued **(Figure 23 overleaf)**. The FSA has publicly indicated that it expects to impose higher penalties in the area of market abuse and insider dealing in the interests of achieving effective deterrence.

22 Enforcement cases opened by the FSA between 2000-01 and 2005-06



Source: FSA and National Audit Office

NOTES

1 The total figure for 2001-02 is 444 cases.

2 Segmented data is only available from 2003-04.

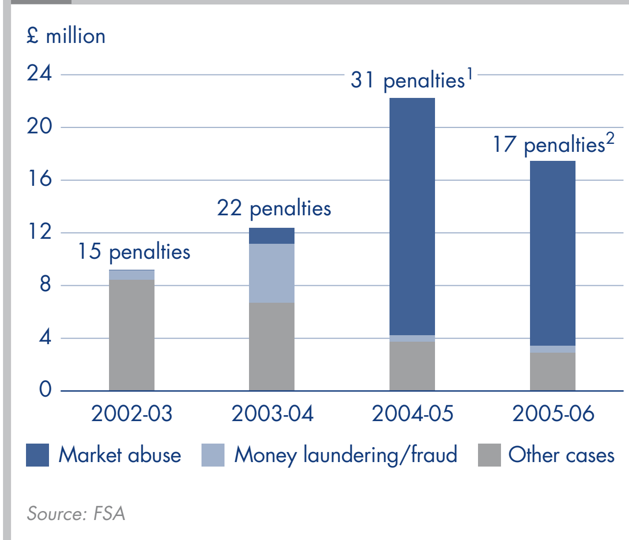
4.64 Enforcement outcomes generate significant publicity and can play a significant role in making consumers and the industry aware about issues of concern. The FSA can therefore use enforcement outcomes as a way of changing behaviour and achieving effective deterrence. It may also use information on enforcement outcomes to increase consumer knowledge and understanding of the financial services markets. As the FSA's approach develops, so it may adapt its use of enforcement. For example, as it becomes a more principles-based regulator it may increasingly enforce on the basis of a breach of one or more of its Principles of Business.

Monitoring and self-review

4.65 The FSA has a lower enforcement case volume than some other financial regulators. In the US, for example, in the financial year 2006 the Securities and Exchange Commission (SEC) initiated 914 investigations and separately filed 218 civil proceedings and 356 administrative proceedings.[124] The proportion of case types does, however, appear to be similar between the FSA and the SEC. The SEC aims to pursue between 12 and 15 per cent of its caseload in market manipulation and insider dealing cases. This is a similar proportion as the FSA caseload in these areas. The FSA's enforcement case volume reflects its supervision-led approach in which enforcement is regarded as only one of the tools for dealing with non-compliant behaviour and resources are allocated accordingly.

4.66 The FSA could explore the feasibility of benchmarking itself against international peers to give it a better understanding of what suitable enforcement goals it could establish in terms of case types, throughput, timescales and even staffing of the enforcement function.[125] This sort of comparative work, whilst very difficult to carry out, may help confirm whether the levels of resourcing of enforcement in the UK match the relative size and importance of its financial markets.[126] It may require the FSA to encourage other regulators to produce outcome-focused market measurements so it can determine which would be the most suitable comparators.

23 Financial penalties issued by the FSA



Source: FSA

NOTES

1 Includes £17 million penalty imposed on Royal Dutch/Shell.

2 Includes £13.96 million penalty imposed on Citigroup.

PART FIVE

Financial Capability

The effectiveness of the FSA's work on Financial Capability depends on how well it understands current levels of financial capability, sets out its objectives for improvement, designs and implements programmes and projects targeted at achieving significant levels of change in consumer capability and evaluates the success of its activities in achieving its aims.

This section shows:

- **overall allocation of resources to financial capability**

  The FSA has taken a strategic lead in addressing financial capability. It identified low financial capability among UK consumers as a risk for financial services markets. To understand and address this risk, it carried out a comprehensive survey of current standards and started to implement projects to improve financial capability. It plans to spend around £90 million in this area between 2006 and 2011. At present it cannot easily quantify the costs of low financial capability to society or how far it is helping to improve the situation so that it can judge if this allocation of resources is appropriate (paragraphs 5.1 to 5.19).

- **working with other organisations on financial capability**

  In providing leadership and coordination, the FSA has played a major role in placing financial capability on the agenda of government and the financial services industry. The FSA is also working successfully with a range of partners to deliver its projects. It regards its role in building financial capability as long-term and has set five year expenditure plans to provide certainty for industry and delivery partners. Links between the projects and between the National Strategy for Financial Capability and the FSA's other regulatory activity could be improved. The FSA has not yet set out its high level priorities and approach for its financial capability work post-2011 (paragraphs 5.20 to 5.35).

Overall allocation of resources to the National Strategy for Financial Capability

5.1 The FSA is a world leader in financial capability. It identified that consumers are facing risks from inadequate understanding of financial concepts and products at a time when they are being asked to take on more responsibility for their long term financial planning. In 2003, responding proactively to this risk and under its statutory objective to improve public understanding of the financial system, the FSA launched an ambitious National Strategy for Financial Capability. Financial capability is a broad concept, encompassing people's knowledge and skills to understand their own financial circumstances, along with the motivation to take action. The FSA has set out a vision of encouraging 'better informed, educated and more confident citizens, able to take greater responsibility for their financial affairs and play a more active role in the market for financial services'[127].

5.2 To support its strategy the FSA has committed to spending £15 to 20 million on financial capability each year between 2007 and 2011. In 2007-08 this will represent approximately 5.7 per cent of the FSA's total budget, up from 1.4 per cent in 2004-05 **(see Figure 24 overleaf)**.

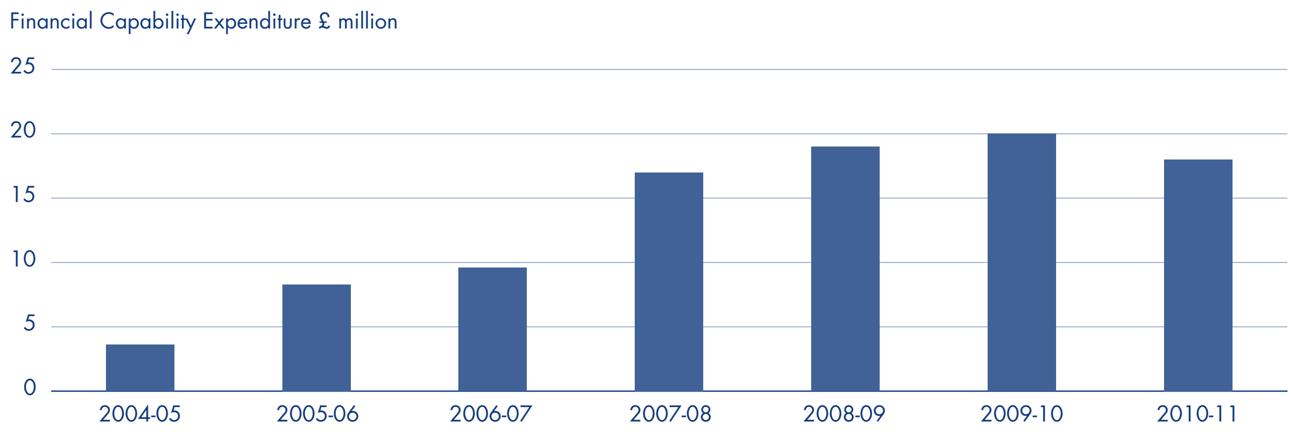
5.3 The FSA's approach to financial capability goes beyond the provision of information, and focuses on shifting attitudes and behaviours – for example choosing a financial product is not a purely rational decision; consumers must also have trust and confidence in the supplier and product they select. Changing consumer behaviour is a more challenging task for the FSA to undertake. But it is more likely, if successful, to lead to positive outcomes for consumers.

5.4 Government guidance on effective communication with customers, including communication designed to shift individual behaviour, emphasises the need to understand people's motivations, needs and barriers; segment and target key audiences; use a variety of communications channels; and collaborate with policy and service delivery partners and stakeholders.[128]

5.5 The FSA has followed this approach. In addition to providing consumer information through its revamped website, online tools and publications, the FSA has developed, piloted and is beginning to implement a series of projects which are aimed at improving financial capability in a range of key audiences – particularly schoolchildren, young adults, employees and new parents. In March 2006, the FSA published a comprehensive baseline survey into levels of financial capability in the UK **(Figure 25)**.

5.6 These activities put the FSA ahead of most of its international peers in financial capability. For various reasons, including resources and remit, most international comparator organisations generally confine themselves to information provision and awareness raising activity. For example, the US General Accounting Office found that the US National Strategy for Financial Literacy was largely descriptive without a plan for implementation.[129] International bodies regarded the FSA's baseline survey as a model for their own work. The Financial Regulator

24 FSA expenditure on Financial Capability 2004-05 to 2010-11



Source: National Audit Office analysis of FSA figures

NOTE
Expenditure for 2007-08 – 2010-11 is forecast.

25 FSA's baseline survey of Financial Capability in the UK

In 2006, the FSA published the results of a nationwide survey of 5,328 people designed to measure levels of financial capability in the UK. National Audit Office experts in survey design examined the methodology and findings of the survey and found it comprehensive and professional.

The FSA identified four key themes from the survey results:

- large numbers of people, from all sections of society, are not taking basic steps to plan ahead;
- although only a small proportion of the population is experiencing problems with debt, they are often very severely affected and many people could be tipped into financial difficulties by a small change in their circumstances;
- many people are taking on financial risks without realising it, because they struggle to choose products that truly meet their needs;
- the under-40s, on whom some of the greatest demands are now placed, are typically much less financially capable than their elders.

It would have been preferable if the FSA had had the survey results available before it drew up its seven priority areas for the National Strategy for Financial Capability, although waiting for the results would have delayed implementation. The FSA is, however, now using the results of the survey to inform its priorities for the national strategy and its wider regulatory work to help retail consumers achieve a fair deal. The FSA also intends to repeat the survey every four to five years to measure the impact over time of initiatives to improve financial capability, including its own seven point programme of action.

Source: National Audit Office

in Ireland has commissioned its own survey based on the FSA's. The FSA has also been able to learn from the work of international organisations. For example, it used the New Zealand Retirement Commission's financial capability website 'Sorted' as a best practice example when redesigning its own consumer website.

5.7 There are two main rationales for interventions to improve financial capability: social justice motivations such as reducing financial exclusion and problem debt; or market outcomes including increased competition and personal responsibility and therefore less regulatory interventions. The FSA has clearly explained the benefits of improved consumer financial capability to both society and the market in broad terms. However, it has not quantified the costs of low financial capability or the benefits of improvements to the consumer, the financial services industry or society in general.[130] Nor has the FSA set out examples of the circumstances in which consumer capability would have reached the necessary level for it to reduce its regulation of the financial services market or its expenditure on financial capability.

5.8 Using the Financial Capability survey, the FSA defined the core skills which consumers need to manage their money well and to engage effectively with the financial services industry. These are reflected in its financial capability projects and consumer information. But the FSA has not yet brought this together with other regulatory information to articulate its vision of the rights and responsibilities of consumers when dealing with financial service markets and how the FSA's financial capability programme and wider regulation will help achieve that vision. It will be important to coordinate with other organisations involved in financial capability to ensure consumers receive coherent messages about their rights and responsibilities.

5.9 The FSA's Financial Capability survey will be repeated every four to five years and was specifically designed to show where initiatives are having most effect and where more work is needed, which demographic groups are being reached, which messages are getting through and how rapidly the FSA are making progress.[131] However, the FSA has not set out the shifts in financial capability levels it expects to see in the next Financial Capability survey in 2010-11. The FSA does not believe that the Financial Capability survey is a suitable tool against which to set objectives and does not expect to see real improvement appearing in these trends for fifteen years or more.[132] It is therefore important that evaluation of the overall impact of the programme is carried out in the medium term.

5.10 The planned overall outcomes for the Financial Capability Strategy cover the full range of measures including input measures such as resources, the number of people reached, changes in consumer behaviour and improved outcomes. However, measures relating to changes in behaviour and improved outcomes are not quantified and are inherently difficult to measure (Appendix 5a has a full list of planned outcomes). Without being able to estimate or measure the impact of its work on consumer behaviour and outcomes, the FSA cannot assess if its overall allocation of resources to financial capability is appropriate.

Allocation of resources to financial capability projects within the National Strategy

5.11 Under its National Strategy for Financial Capability, the FSA identified seven priority areas in which to target their work. These are schools; young adults; workplaces; consumer communications; online tools; new parents; and money advice. Three of the priority areas (schools, young adults and new parents) target key life stages – an approach recommended by consumer experts.[133] The FSA has also made efforts to target other interventions at specific demographic or socio-economic groups based on the findings of the baseline survey, for example particularly recruiting employers with a higher proportion of young or lower income staff for the workplace seminars.

5.12 A number of stakeholders felt that older people should also have been a priority area under the Financial Capability strategy. The FSA is looking to reach older people by working with intermediaries as part of its money advice strategy. It also plans to look at how it meets the needs of older people as part of its examination into the issues arising from greater life expectancy, changes in lifestyle and the increasing need for consumers to take personal responsibility for their financial affairs. Some stakeholders also considered the National Strategy should have had greater focus on disadvantaged groups. The FSA is focusing on the needs of disadvantaged groups through its Innovation Fund projects and wider financial inclusion activities such as its work with Credit Unions.

5.13 Working with a variety of delivery partners, the FSA developed business cases for a range of projects in these priority areas. It undertook pilot projects in each area, and evaluated the results, before committing further expenditure **(Figure 26 overleaf)**.

26 FSA's Financial Capability projects in delivery phase

- **Learning Money Matters:** a comprehensive 'One Stop Shop' service to provide teachers with support, training and resources to deliver personal finance education.
- **Money Doctors:** a toolkit for universities offering new and proactive approaches to engaging students to take control of their own finances before they face difficulties, and to confront debt problems.
- **Fairbridge West:** 'On Your Own 2 Feet': A practitioner toolkit on embedding money management and financial skills into existing courses, one-off sessions and stand alone courses for the most vulnerable and hard to reach young people.
- **Citizens Advice:** 'Frontline Training': financial capability training for intermediaries working with young people such as social services, youth offending teams and Connexions personal advisors.
- **Make the Most of Your Money:** financial education booklet and seminars delivered to employees through their workplace.
- **Consumer Communications:** more targeted, engaging and accessible consumer communications through the FSA website and publications.
- **Online tools:** development and distribution of online tools such as the 'Financial Healthcheck' and the 'Debt Test' to help people to assess their financial situation and, if necessary, to take action and get further help.

A number of pilots for further projects for young adults, in the Further Education sector and for new parents are still taking place. In addition, several smaller scale projects have been funded through the Innovation Fund.

Source: National Audit Office

5.14 The budget and reach of each project varies. For example, over five years the budget to achieve a 'significant' increase in the number of visitors to FSA online tools is just under £5 million whereas the budget to provide workplace information to four million people, 500,000 of whom should attend a seminar, is £13 million. However, the numbers of people reached, although important, are not the key indicators of success of a programme aimed at changing individual behaviour and outcomes. **Figure 27** sets out potential costs of the projects per person reached alongside some comments on the potential of the projects to impact on the behaviour and outcomes for consumers dealing with the financial services market. These costs only refer to FSA expenditure. The FSA's financial capability projects also benefit from resources contributed from stakeholders such as teachers, the Qualifications and Curriculum Authority and employers. It is difficult to quantify these resources and therefore they have not been included.

Evaluating the success of the financial capability projects

5.15 The FSA has developed an impressive range of targets in each of its seven priority areas (see Appendix 5b). It has outlined 39 targets over the seven areas to be met by 2006-07 and a further 26 to be met by 2010-11. This includes targets on infrastructure, funding and reach. For example the FSA aims to send four million people financial information through the workplace by 2011, with 500,000 attending a seminar. Outcome related targets such as 'evaluation shows that consumers using [FSA] information demonstrate improved financially capable skills/behaviours' are not quantified and are difficult to measure. Developing its evaluation of the impact each project has on participants' behaviour and outcomes, alongside the results of the Financial Capability survey, will help the FSA make judgements about the appropriate allocation of resources within financial capability.

5.16 The FSA makes provision for evaluation of all of its major projects and collects a range of information to assess success. For example the FSA surveys participants before and after its workplace seminars although there are limitations to the usefulness of this information **(Figure 28 on page 57)**. The FSA could make more of the opportunity provided by workplace seminars. Research suggests that financial education programmes delivered through the workplace can be evaluated using the information held by employers such as employee participation in pension schemes. If this information can be collected in advance, any changes following the seminar can be measured.[134] And studies in the US have managed to show that, controlling for other factors, median savings rates are 22 per cent higher for individuals whose employers offer financial education.[135]

27 Costs, reach and potential impact of Financial Capability projects

Priority Area	Description	Cost per person reached 2006-11	Potential to impact on consumer behaviour and outcomes
Schools: Learning Money Matters	Working with the personal finance education group to provide teachers with support, training and resources to deliver personal finance education.	***£10.33 per person reached*** Target: 1.8m children Budget: £18.6m	■ Uses a life stage approach, although not at a time of key financial decisions; ■ US research suggests financial education in schools can positively impact on financial outcomes in later life; ■ School education programmes used in other sectors e.g. health improvement and sustainability; ■ Can provide some tailored information to individuals; ■ Works through trusted intermediaries; ■ Benchmarking survey of financial education in schools undertaken, toolkit being developed to assess student progress, achievement and confidence; ■ Clear strategy for reducing expenditure while maintaining impact.
Young Adults: Helping Young Adults Make Sense of Money	A variety of projects with a range of partners aimed at university and further education students and young adults not in employment, education or training.	***Not available*** Target: Not yet developed Budget: £10.7m	■ Uses a life stage approach; ■ Reaches young adults at key decision points such as starting university; ■ Targets some vulnerable groups; ■ Can provide some tailored information to individuals; ■ Works through trusted intermediaries and sector experts; ■ Evaluation framework to assess benefits to youth work organisations in achieving their own targets and a self assessment tool for young adults are being developed; ■ Some potential for impact to continue after FSA funding reduced.
Workplace: Make the Most of Your Money	Education packs and seminars on key financial issues delivered to employees in the workplace.	***£3.33 per person receiving information*** Target: 4m people receive information, 500,000 attend a seminar Budget: £13.3m	■ Although targeting a broad audience, it allows for further segmentation through targeting particular workplaces; ■ Research from the US suggests workplace education can positively impact on financial outcomes; ■ Evaluation shows an average of 60 per cent of participants have taken action on their finances three months after participating in a seminar; ■ Linked with key financial decisions made due to employment e.g. on pensions or income protection insurance.

27 Costs, reach and potential impact of Financial Capability projects *continued*

Priority Area	Description	Cost per person reached 2006-11	Potential to impact on consumer behaviour and outcomes
Consumer communications	Revamped consumer website and publications to provide information on a wide range of financial issues supported by specific consumer campaigns.	***£3.85 per person reached*** Target: 4m people Budget: £15.4m	■ Although website targets a broad audience, publications and campaigns can be targeted at segmented populations and those at key decision points; ■ Considerable consumer research carried out in support of revamped consumer website and publications; ■ Easily accessed, wide ranging information available although it cannot be tailored to individuals; ■ Consumer campaigns may help overcome lack of awareness of FSA consumer role.
Online tools	Increasing the use of the Financial Healthcheck and Debt Test through syndication to partner websites.	***Not available*** Target: a 'significant increase' Budget: £4.9m	■ Easily accessed information which could prompt further action; ■ Some tailoring of information; ■ Some opportunities for segmentation and targeting through selection of partner websites.
New parents: the Parents Guide to Money	Development and distribution of a toolkit for new parents to provide information on all the financial issues associated with parenthood.	***£8.53 per person reached*** Target: 1.5m new parents Budget: £12.8m	■ Follows a life stage approach; ■ Targets particular segment of the population at a key decision point; ■ Likely to use joined up delivery channels and trusted intermediaries such as workplaces and health professionals.
Money advice	Developing a general unregulated financial advice service. The government is now leading in this area.	***Not available*** Target: No target on reach (projects not yet developed) Budget: £7.2m	■ HM Treasury has commissioned a taskforce to design a generic advice capacity; ■ The FSA is focusing on building capacity to provide basic "entry level" advice through intermediaries for example by developing more widely successful projects from the Innovation Fund (see below); ■ Work by the Resolution Foundation suggests a national generic advice service could lead to improved financial outcomes.
Innovation Fund	Provides funding for smaller projects with potential for wider replicability across a number of sectors aimed at improving financial capability.	***Cost per person reached will vary depending on the project. An example figure from one of the most advanced projects is £3.34 per person reached***[1] Reach: 3,964 (at end of January) Expenditure: £13,242	Depends on projects, but: ■ Potential to target audiences by life stage, key decision points and other segmentations e.g. project aimed at offenders; ■ Access to vulnerable groups; ■ Works through trusted intermediaries and sector experts; ■ Can provide some tailored information; ■ Potential for impact to continue once FSA expenditure reduced.

Source: National Audit Office

NOTES

1 Omagh Independent Advisors project to develop a booklet and website of financial advice for families of those suffering with cancer. Figure will decrease over time as the number of visits to the website increases.

2 Cost per person reached figures are estimates based on provisional budgets up to 2011-11 and therefore subject to change.

28 FSA's Evaluation of workplace seminars

Seminar participants fill in a short questionnaire rating their knowledge, understanding and ability before the seminar. They are then asked to re-rate themselves after the presentation. Participants are also asked if they are likely to take action as a result of the seminar. The FSA contacts a sample of participants three months after the session to find out if they have actually taken action. To date an average of 60% have taken action.

This approach is an encouraging early attempt to evaluate the impact of the programme on consumer behaviour. For several reasons, however, it is of limited use. The questionnaire relies on self-assessment and is therefore subjective. The range of actions to take is limited and includes options such as "generally review my money affairs, plans and goals": such an action may have no effect on behaviour. The evaluation provides no information on whether improved outcomes were achieved. To date the follow up has only been carried out after three months and cannot yet provide any long term data. The FSA is putting in place plans to develop and improve its evaluation of workplace seminars.

Source: National Audit Office

5.17 The FSA recognises that it needs to develop the evaluation side of its work in order to demonstrate its increased investment is providing value for money. Yet evaluating the outcomes of behaviour change programmes is difficult. The FSA is concerned that it might set arbitrary measures and may not be able to attribute a change in behaviour to its own work. The FSA could consider the following options:

- **Extrapolating from previous trends, academic research and studies on the experience of other organisations:** Research in the US shows that, controlling for other factors, people aged 35-49 who had received financial education were better off by about one year's worth of earnings and tended to save about 1.5 per cent more of their income each year compared to those who had not received financial education.[136] Transposing these results to the UK, the IPPR suggested that, for example, by their late forties the average couple with no children could be around £22,000 better off as a result of having taken better financial decisions throughout their lives.[137] The FSA may be able to use similar techniques to predict an achievable level of impact its projects may have;

- **Exploring the use of modelling techniques:** The FSA has previously carried out research which aimed to quantify savings to consumers from acting in a more financially capable way, for example it showed that a typical consumer could gain between £70 and £710 a year by making better financial product choices.[138] The Resolution Foundation has attempted to model the potential impact of providing financial advice to people on low to moderate incomes suggesting, for example, that young people could experience an increase in annual retirement income of £1,500.[139] The FSA may be able to use similar techniques to predict potential quantified savings for consumers benefiting from their programmes.

5.18 The FSA may be able to build on its successful record of consumer research by using sophisticated methodologies to demonstrate a clearer link between improved outcomes and its own work. For example, it could revisit the possibility of complementing its survey with longitudinal research to track the outcomes of those involved in its programmes. Even more valuable would be to compare these outcomes with a 'control' group who had not been involved in an FSA programme. The FSA could also consider developing joint outcome-based indicators with other bodies whose work will affect levels of financial capability such as HM Treasury.

5.19 It may be possible for the FSA to make use of existing information. Data on the financial position of consumers and their interaction with the financial services industry is collected by a number of different bodies including firms, local authorities, consumer bodies and market research companies. In some cases, the FSA may need to use new interpretations of data to evaluate the cause of changing trends. For example, an increase in complaints – traditionally regarded as a signal of market problems – could indicate consumers are becoming more aware of their rights as capability increases.

Working with others on financial capability

Providing leadership

5.20 The FSA has highlighted the issue of low financial capability in the UK and put it on the agenda of government and the financial services industry. In 2003, the FSA set up a Financial Capability Steering Group made up of senior and influential individuals from the FSA, government, industry and the voluntary sector and issued a series of documents developing a National Strategy for Financial Capability and an action plan for implementation.[140] The steering group identified seven priority areas and convened working groups to develop proposals for action.[141] Between 2003 and 2007, over 100 expert representatives from a wide variety of organisations have been involved in these working groups. The FSA provided vital coordination and direction; the OFT's mapping of consumer education found that financial education appeared to be the most coordinated topic of those examined, with the FSA Financial Capability Initiative leading and other overarching activities coordinating gaps and duplications.[142]

5.21 Working group members consider the FSA to be outward facing and to have made a real effort to be inclusive. The FSA reached important people in a range of sectors. This is particularly impressive given the FSA has reached out to organisations, particularly in the voluntary sector, with which it would not usually have contact. Working with different organisations could require the FSA to adopt different approaches from the rest of its work. For example, stakeholders felt the working group discussions often had limited influence on the FSA's wider programme and that the FSA could have consulted earlier in the development of its strategic thinking on financial capability.

5.22 Stakeholders also emphasised the importance of the FSA and government working together on financial capability. This joint approach was exemplified through the first joint FSA/HM Treasury conference on Financial Capability in November 2006 and the publication of the Treasury paper on the government's long term approach to financial capability in January 2007 announcing the creation of the Thoresen Review to design a national generic advice service.[143] As the regulator of the financial services industry and lead organisation on financial capability the FSA will need to remain closely involved in the development of such a service. For example, the FSA is seconding staff to the Thoresen Review taskforce.

5.23 The FSA has worked hard to involve the financial services industry in its Financial Capability Strategy. Representatives from firms and trade bodies sit on the Financial Capability Steering Group and have been involved in the working groups; financial advisors are used to deliver the workplace seminars and the FSA currently has a number of secondees provided for free by industry. The financial capability team has also presented to the Boards or senior committees of many of the major financial industry trade bodies and, for example, the Association of British Insurers told us that generally its members thought that funding the FSA's financial capability programme through the levy was appropriate, so long as it proved to be value for money.

5.24 Some industry representatives in our focus groups expressed scepticism about the FSA's financial capability work and the Financial Services Practitioner Panel showed that 31 per cent of firms rated FSA's performance on 'improving public understanding of the financial system' poorly and only 16 per cent rated it well **(Figure 29)**.

Working with delivery partners

5.25 A number of the financial capability projects are now being fully implemented by the FSA and its delivery partners. Learning Money Matters, the free support service for schools, and *Making the Most of Your Money*, the information packs and seminars delivered through the workplace, are now being delivered to target audiences. The Parents Guide to Money, the advice pack for new parents, is still in pilot stage.

5.26 The FSA's progress on Money Advice has moved most slowly. A not-for-profit organisation, the Resolution Foundation, has been the lead body in research and lobbying on developing a generic advice capacity. The government is now taking the lead on money advice with its Thoresen Review of Generic Financial Advice and the FSA has reallocated its Money Advice resources to working with intermediaries to develop capacity to provide entry level money advice. This will include developing more widely projects from its Innovation Fund. The Innovation Fund provides seed funding for small scale financial capability projects with potential for replication on a national scale **(Figure 30)**. The large scale development of some Innovation Fund projects provides the potential to target some important groups based on the findings of the baseline survey such as older people or social housing tenants.

29 Practitioner views of the FSA's performance in improving public understanding of the financial system

Category	Rating (out of ten)	Percentage of regulated firms %
Good	7–10	16
Average	4–6	50
Poor	1–3	31
No answer	N/A	3

Source: Financial Services Practitioner Panel Survey of Regulated Firms

30 Innovation Fund

The FSA launched the Innovation Fund in June 2005. It provides a total of £200,000 in seed funding to small organisations across a variety of sectors to develop projects aimed at improving financial capability. The fund aims to take advantage of the knowledge and contacts of sector experts in a 'bottom up' approach to financial capability.

One of the key criteria for selection is a project's potential for replicability on a national scale. The FSA will provide support and extra resource to help organisations develop initial outputs into toolkits and other products which can be rolled out more widely with the help of umbrella organisations. For example, the FSA provided £35,000 to London & Quadrant Housing Trust to enable them to carry out one-to-one sessions with social housing tenants to provide them with financial capability advice leading to a personalised action plan. The FSA then worked with the Chartered Institute of Housing, providing an extra £4,000 funding, to produce a good practice guide that is anticipated to reach around 25-30,000 housing officers and affiliated professionals, helping them to help their clients with day-to-day money and benefits decisions. This represents a cost of £1.42 per housing officer reached.

Source: National Audit Office

5.27 The FSA's partners are positive about their relationships with the FSA. They appreciated that the FSA has involved sector experts and trusted intermediaries to deliver the projects. In their opinion, the FSA had generally achieved the correct balance between providing strategic input and close support and allowing delivery partners the necessary autonomy. Stakeholders also praised the FSA's use of secondments to and from delivery partner organisations to support the development of the projects.

5.28 One of the key challenges for the FSA is to increase and exploit the linkages between the projects. Partners were often not aware of activity on other priority areas which they felt could be relevant to their own projects. For example, workplace seminars do not always make the relevant references to other financial capability projects.

Long-term plans for financial capability

5.29 Most stakeholders consulted by the NAO suggested that the FSA's expenditure of up to £20 million per year is insubstantial given the scope of the problems revealed by the Financial Capability survey. There is no complete picture of the total resource spent on increasing financial capability by government, industry, the voluntary sector and other bodies in the UK.[144] Given the FSA's primary role as regulator, it does not consider it appropriate to spend greater amounts of money. Instead, it sees its commitment as a way of encouraging other organisations to contribute. Echoing this, most stakeholders told us that any significant extra funding should now come from government or the financial services industry.

5.30 The FSA has committed £90 million expenditure on Financial Capability up to 2011. It does not have a clear longer-term resource allocation strategy beyond 2011. Many stakeholders from a variety of sectors expressed doubt as to whether the regulator is the correct body to lead on financial capability in the long term. Despite these doubts, many concluded no other body was obviously better placed to take the lead and views differed on what degree of responsibility should lie with government, the financial services industry or other organisations such as the Office of Fair Trading[145]. Some stakeholders expressed concern that the FSA, whose primary role is regulating financial institutions, may not be able to devote the necessary resources and attention to financial capability. They also questioned whether the regulator was the best body to undertake programmes designed to change consumer behaviour.

5.31 The Government has set out its long-term approach to financial capability.[146] The FSA regards its role in building financial capability as long-term. It has set five year plans for its priorities and expenditure plans to provide certainty for industry and delivery partners. These plans may change over time. For example, the FSA estimates a reduction in expenditure on schools education from 2009-10 as financial capability becomes more embedded in the curriculum. It also hopes that the industry will be more willing to take on responsibility for delivering workplace seminars in future. It is important that the FSA, in consultation with its stakeholders, begins in good time to develop its strategic priorities and approach for financial capability beyond 2010-11.

5.32 Other than through funding of the FSA, financial services institutions have no obligation to spend any money on increasing consumer capability. Nevertheless, many firms do so through their corporate social responsibility budgets or through their advertising, marketing and customer relations activities. There is a risk that if the FSA delivers large-scale capability projects, it may deter some firms from their own activity – although there is some evidence that the FSA's programme is stimulating, rather than crowding out, firms' own projects.

5.33 The National Strategy for Financial Capability focuses on stimulating the demand side through increasingly capable consumers. To complement its work here the FSA could also set out its strategy for delivering the supply side of financial capability including the responsibilities of firms to respond to current levels of consumer financial capability through, for example, product innovation, provision of information and financial promotions.

5.34 As shown in Appendix 5c, improving financial capability is integral to the FSA's strategy for helping financial services consumers achieve a fair deal. Capability levels are closely connected to many other retail and consumer needs and priorities. For example, as set out in the Better Regulation Commission report *Risk, Responsibility and Regulation*, firms should produce information with a genuine desire to inform consumers with different levels of expertise and experience rather than simply to avoid litigation.[147] Financial capability is an important issue in some of the FSA's major retail regulation activities including:

- **the development of a more principles-based approach to Treating Customers Fairly** – aims to make senior management of financial services institutions take on greater responsibility for ensuring their firms pay due regard to the interests of customers and treat them fairly. The six consumer outcomes outlined by the FSA, including 'consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale' and 'consumer advice is suitable and reflects consumer needs, priorities and circumstances' are closely related to financial capability issues. Treating a customer fairly may mean different courses of action depending on levels of capability;
- **its Retail Distribution Review** – aims to identify and address the root causes of problems in the retail investment market. It will look at the sustainability of the sector, the impact of incentives, professionalism and reputation, consumer access to financial products and services; and regulatory barriers and enablers. These factors all impact on the capability and confidence of consumers in dealing with the finanical services markets;
- **its regulation of Financial Promotions** – the FSA regulates financial promotions to ensure they are 'clear, fair and not misleading'. An important factor for the FSA to consider in its regulation of financial promotions is the degree to which firms should take into account, and not take advantage of, low consumer levels of financial capability.

5.35 In some of the FSA's material, such as *Treating Customers Fairly – towards fairer outcomes for consumers*, financial capability is a key theme and findings from the baseline survey are used throughout the publication.[148] However, in other areas such as investment disclosure research, financial capability appears to be less of a factor. The National Audit Office survey of FSA supervisory staff showed that 39 per cent rarely or never discuss the financial capability of consumers in discussions with supervised firms. The FSA is aware of the need to raise the internal profile of financial capability issues to ensure it is embedded across the organisation and not confined to the activities of one department.

SCOPE AND METHODOLOGY

1 The National Audit Office was invited by HM Treasury on 21 June 2006 to review the economy, efficiency and effectiveness with which the Financial Services Authority (FSA) has used its resources in discharging its statutory functions. The review was carried out under Section 12 of the Financial Services and Markets Act 2000. Under the terms of reference of the invitation (full terms of reference are included on page 67), HM Treasury asked the NAO to look at five broad areas of the FSA's work:

- internal performance management;
- external joint-working in the UK;
- influencing and representation internationally;
- financial crime; and
- financial capability.

2 The key elements of our study methodology are outlined below:

31 Review methodologies

Section	Methodology
1	Document review and case study analysis
2	Process mapping
3	Data analysis
4	Work observation
5	Staff interviews
6	NAO survey of FSA supervisors
7	Other surveys
8	International interviews
9	Industry interviews and discussion groups
10	Stakeholder and partner consultation and interviews
11	Correspondence and web log monitoring

Source: National Audit Office

1. Document review and case study analysis

3 We examined a wide range of documents published by the FSA, and those generated internally. For each of the five terms of reference areas, we identified the main strategic documents in which the FSA sets out the outcomes it aims to achieve and the work programme to deliver these aims. We then sought to identify where and how far the outcomes and work programmes are reported publicly; and how they are recorded in internal performance management information reported to senior executives, the main FSA Board, and non-executive directors. In this way, we integrated our audit approach, with the performance management strand of the terms of reference forming the central element, focusing on how far performance management information focuses on appropriate outputs and outcomes. For the other four strands, we sought to identify how far the FSA had integrated them into the overall performance management approach via a clear identification of intended outputs and desired outcomes.

4 In addition, we identified a series of case studies that illustrated how the FSA approaches its work in each of the five terms of reference areas. These case studies served two purposes: firstly, they enabled us to understand the practical challenges and solutions that the FSA faces in a wide range of areas; and secondly, they provided evidence that we have used throughout our report to illustrate important points. The main case studies we reviewed were:

Part 2: Working with other UK regulators

- Payment Protection Insurance (Figure 9)

Part 3: Influencing and representation internationally

- Markets in Financial Instruments Directive: assessment of costs and benefits (Figure 10) and directive timeline (Figure 11)
- Credit rating agencies (Figure 12)
- Credit derivatives and bi-lateral working (Figure 13)

Part 4: Financial crime

- High profile anti-money laundering fines issued by FSA (Figure 19)

Part 5: Financial capability

- FSA's baseline survey of Financial Capability in the UK (Figure 25)
- FSA's Evaluation of work-place seminars (Figure 28)
- Innovation fund (Figure 30)

2. Process mapping

5 We mapped the FSA's performance management process. We did this by tracing how performance information is generated, reviewed and reported, and we interviewed FSA staff responsible for producing performance management information to ascertain how they used the information. This work involved mapping two separate processes: firstly, that involved in the generation of the FSA's existing internal performance management information; and secondly, that involved in the FSA's new Outcomes Performance Report, which identifies 9 high-level outcomes from the FSA's work.

6 We carried out an informal high-level benchmarking exercise of the FSA's performance management system against the performance management maturity model set out in the National Audit Office's Efficiency Toolkit published in 2006. More information on this exercise is detailed in Appendix 1a).

3. Data analysis

7 To carry out its work under our five terms of reference the FSA produces a large and varied amount of data such as cost estimates, consumer and industry research, web trends, enforcement statistics and project evaluations. Such data is integral to the FSA's internal thinking, stakeholder relationships and the conclusions and decisions it reaches. Based on a review of documents and interviews with FSA staff we identified the key data for each terms of reference area. We then conducted further analysis of the data to assess its robustness and draw out key trends and patterns. The main data sets and documents we analysed were:

Performance management

- Correlations between time recording and risk assessments for individual firms
- Executive Committee Management Information Packs
- Business Unit Management Information Packs
- Economy and efficiency reports

Working with other regulators

- Memorandums of Understanding (FSA & TPR; FSA & FRRP); Joint Action Plan (FSA & OFT)
- Minutes of joint meetings
- Relationship structure charts
- Case summaries illustrating joined-up working

International representation

- FSA's EU and Global Strategy
- FSA briefing papers for EU and international committees
- Financial Services Practitioner Panel and Consumer Panel surveys
- Case summaries evaluating FSA influencing in EU and internationally
- Estimates of staff time booked to EU and international activities

Financial crime

- Financial crime budgets
- Training statistics
- Communications releases
- Staff time booked to combating financial crime activities
- Enforcement case volumes, penalty decisions and ratio of opened cases to enforcement actions

Financial capability

- Overall financial capability expenditure and budget figures
- Financial capability project budgets
- Baseline survey on Financial Capability

4. Work observation

8 The FSA's work under our five terms of reference areas involves the use of a variety of internal and external meetings and similar to make decisions; develop thinking; and communicate with industry and consumers. To enhance our understanding of how the FSA operates, we attended relevant meetings in an observer capacity, as follows:

Performance management

- ARROW 2 training course
- ARROW pre-visit meeting and post-visit validation panel meeting
- Firm Contact Centre
- Small Firms Division roadshow

Financial Crime

- Risk Committee (Fin Crime)

Financial capability

- Joint HMT/FSA Financial Capability Conference
- Financial Capability Steering Group
- Financial Capability workplace seminars
- Higher Education Early Developers meeting

5. Staff interviews

9 We conducted interviews with a broad range of FSA officials from across the organisation. For each terms of reference area there was a lead member of staff who provided information about the FSA's work in that area, and facilitated meetings with relevant contacts within the FSA who were best-placed to answer our detailed questions. In total, we held over 70 interviews with FSA staff members.

10 In addition, the NAO held meetings with each member of the FSA's executive committee, principally to ascertain the use made of performance management information; and a majority of the FSA's Board members, where we sought views in particular on the information provided to Board members on the FSA's performance, and also Board members' views against each of the terms of reference questions.

6. NAO survey of FSA supervisors

11 Based on the findings from our early fieldwork, the NAO decided there was a need for further evidence from the FSA supervisory staff on certain key areas: the nature of their work, the FSA's work on combating financial crime, the FSA's work on improving the public's financial capability and the overall performance of the FSA. We therefore developed an on-line questionnaire which was designed to obtain the views of FSA supervisory staff on the relevant issues, rather than sent to all FSA staff. We were also conscious of avoiding duplicating the FSA's own staff survey. Our survey was sent to 580 FSA staff and 391 staff completed it (a response rate of 67 per cent). The results have been drawn on in this report as appropriate to give an additional layer of evidence.

7. Other surveys

12 With assistance from NAO experts in survey design, we reviewed and analysed the results from several other relevant surveys outlined in **Figure 32**.

32 Other relevant surveys

Survey	Organisation
Staff Survey 2006 (November 06)	Financial Services Authority
Fourth Survey of the FSA's Regulatory Performance (November 06)	Financial Services Practitioner Panel
BBA member survey of the FSA Regulatory Framework 2005 (December 05)	British Bankers' Association
Banking Banana Skins 2006 (June 06)	Centre for Study of Financial Innovation
Financial Capability Baseline Survey (March 06)	Financial Services Authority
The Competitive Position of London as a Global Financial Centre (November 05) and The Global Financial Centre Competitiveness Index (February 06)	The Corporation of London

Source: National Audit Office, FSA, FSPP, BBA, CSFI

13 We reviewed each survey to determine it was a robust source of evidence. We then conducted secondary analysis to draw out key findings which were relevant to our terms of reference. The results of these analyses informed our other strands of fieldwork, particularly our interviews with FSA staff, industry and other stakeholders. We also triangulated the results of these surveys with our own audit findings to provide an extra layer of evidence.

8. International interviews

14 As the regulator of a major financial market, there is an important international dimension to all the strands of the FSA's work which are covered by the terms of reference. In order to understand the international context in which the FSA works we conducted a number of in-person and telephone interviews with representatives from EU and international bodies and with international comparators.

15 We placed the most weight on this strand of our methodology in examining the FSA's work influencing and representing internationally. In this area we met:

33 International consultees

Area	Meetings conducted
EU consultees	
Committee of European Banking Supervisors	Chair, Secretary General, FSA secondee
Committee of European Securities Regulators	Chair, Secretary General, FSA secondee
Committee of European Insurance and Occupational Pension Supervisors	FSA secondee
European Commission	Director, Financial Services Policy and Financial Markets; Head of Department – Insurance and Pensions; FSA secondee
European Parliament	John Purvis MEP; Wolf Klinz MEP; FSA secondee (Designated National Expert to the Economic and Monetary Affairs Committee)
UK Representation in Brussels	First Secretary, Financial Services
City EU Advisory Group	Chairman
City of London Office in Brussels	Director
European Banking Federation	Head of Department, Banking Supervision and Financial Markets
International consultees	
United States Securities and Exchange Commission	Chairman
Autorité des Marchés Financiers (the French Securities Regulator)	Chairman
Australian Securities and Investments Commission	Chairman
Hong Kong Securities and Futures Commission	Chief Executive Officer

Source: National Audit Office

NOTE

We also spoke to the international security regulators above about financial crime.

16 On financial capability, we interviewed five international comparator organisations by telephone. These were:

- Financial Consumer Agency of Canada
- Australian Financial Literacy Foundation
- New Zealand Retirement Commission
- Financial Regulator in Ireland
- Malta Financial Services Authority

17 We developed a topic guide for the interviews which was designed to gather views on the problem of financial capability, the work of the organisation on financial capability, the resources allocated by each organisation, how its impact was measured and impressions of the FSA's work in this field.

9. Industry interviews and discussion groups

18 As the FSA is funded through a levy on the financial services industry, a vital strand of our methodology was to canvass a wide range of views from businesses. We held a number of discussion groups structured around the terms of reference with trade associations, groups of interested parties and a wide range of businesses. For each discussion, we used the terms of reference questions as a topic guide.

19 We held semi-structured interviews with representatives from a number of trade associations across the financial services sector including:

- Association of British Insurers
- Association of Independent Financial Advisers

- Association of Private Client Investment Managers and Stockbrokers
- British Bankers' Association
- British Insurance Brokers Association
- Council of Mortgage Lenders
- Investment Management Association
- London Investment Banking Association
- National Association of Pension Funds

20 We also interviewed individual firms on specific issues of interest within the terms of reference. These firms were selected due to their particular relevance to the terms of reference areas. For example, we met with the Royal Bank of Scotland on Financial Capability because of their own programme providing financial education in schools. Overall, we held 24 interviews.

21 In the course of these discussions, interviewees frequently made observations and points that went beyond the terms of reference. Where appropriate, we recorded these observations and shared them with the FSA in an anonymised, summarised format, even though they fell outside our detailed terms of reference.

22 We also attended the following discussion groups with interested parties:

- FSA Practitioner Panel: (the Panel provides input to the FSA from the industry in order to help it meet its statutory objectives and comply with the seven principles of good regulation, and represent the interests of practitioners). We met the Panel on three occasions.
- FSA Smaller Businesses Practitioner Panel: (the Panel provides advice on policy initiatives, focusing in particular on the impact of those initiatives on small regulated businesses, and more generally its remit allows the Panel to comment on any specific FSA output as it wishes, and to set its own agenda). We met the Panel once, and also obtained written reponses to a detailed set of questions we shared with the Panel.
- FSA Consumer Panel: (The Panel advises and monitors the FSA on all its policies and activities from an independent consumer point of view. They also review and comment on wider developments in financial services if they feel that consumers are losing out). We met the Panel twice.
- Lloyds of London: (firms represented – **Figure 34**)
- British Bankers' Association: (firms represented – Figure 34)
- London Investment Banking Association: (firms represented – Figure 34)
- Beachcroft consultancy industry panels: (firms represented – Figure 34)

34 Attendees at industry discussion groups

Panels

Financial Services Practitioner Panel

Smaller Businesses Practitioner Panel

Financial Services Consumer Panel

Roundtables organised by:	Firms attending
Lloyds of London	Ace Underwriting Agency Ltd, Advent Underwriting Ltd, Atrium Underwriting Ltd, Beaufort Underwriting Agency Ltd, Beazley Furlonge Ltd, S A Meacock, Wellington Underwriting Agencies Ltd, Whittington Capital Management Ltd
British Bankers' Association	ABN Amro, Abbey National, Credit Agricole, Credit Suisse, HBOS, JP Morgan, Royal Bank of Scotland
London Investment Banking Association	Citigroup, Credit Suisse, Deutsche Bank, Morgan Stanley, UBS
Beachcroft Regulatory Consulting	AEGON, AXA, AIG Europe (UK) Ltd, Amlin plc, Aviva plc, Catlin Insurance Company (UK) Ltd, Chubb, Groupama Insurances, HCC International Insurance Co plc, HSBC, Legal & General Group, Prudential, Royal & Sun Alliance, St Paul Travelers Insurance Co Ltd, Wesleyan Assurance Society, Zurich Financial Services (UKISA) Ltd

Source: National Audit Office

NOTE

We also attended a meeting of the Centre for the Study of Financial Innovation Regulatory Working Group.

- We also convened our own Panel of Experts to advise on our methodology and emerging findings.
  - George Alford – banking and FSA expert (former CEO of Kleinwort Benson and ex-Bank of England, now with Beachcroft Regulatory Consulting)
  - Colette Bowe – consumer and regulation expert (Chair of Ofcom Consumer Panel, non executive director of Morgan Stanley International; Axa Framlington; Yorkshire Building Society)
  - Phil Evans – consumer and regulation expert (ex of WHICH?, now an independent consultant)
  - Rob Falkner – financial services legal expert (partner with Morgan Lewis)
  - John Howell - financial services expert with focus on financial crime issues (independent consultant)
  - Graham Mather – legal and regulatory expert (President of European Financial Forum)
  - Dr. Mark Thatcher – expert in public administration and policy, London School of Economics

10. Stakeholder and partner consultation and interviews

23 The FSA has a number of other stakeholders aside from industry including government, consumers, other regulators, other public bodies and the voluntary sector. Across most of the areas in the terms of reference, it was necessary to speak to organisations with a common interest in particular aspects of the work of the FSA.

24 We held an on-going dialogue with HMT officials who had commissioned the review not only to keep them informed of progress on the review but also to gain their views on the FSA's performance against the areas in the terms of reference.

25 On joint working with other UK regulators, we met the chief executive of each of the three bodies named in the terms of reference (FRC, OFT, TPR) and held follow up meetings with relevant staff at the three bodies. For these meetings we developed a structured questionnaire based on the themes in the Hampton Report to ensure we covered similar areas with each. Questions were asked under the following headings: collaborative working; liaison with the FSA; information sharing with the FSA; reducing the administrative burden on jointly regulated firms; joint training and development; communicating with the public; and general issues of joint working.

26 On combating financial crime, we held meetings with key UK public bodies involved in combating financial crime. At these interviews we discussed their level of cooperation with the FSA on financial crime, as well as issues that effect the effectiveness of joint working between the agencies:

- City of London Police (Economic Crime Department);
- Metropolitan Police Service (Economic & Specialist Crime Command);
- Serious and Organised Crime Agency (Proceeds of Crime Division);
- Serious Fraud Office;
- HM Treasury (Financial Crime team within Financial Services Division);
- Home Office (Organised & Financial Crime Department); and
- HM Revenue & Customs (Anti-Money Laundering Unit & Criminal Investigations).

27 On financial capability, we interviewed key stakeholders including delivery partners under the Financial Capability Action Plan, members and former members of the FSA's financial capability working groups, consumer bodies, and relevant government departments. For these meetings we developed a topic guide based on our desk research and FSA interviews. Topics covered included the scale of the problem, the role of the FSA, the appropriateness of resources applied, the challenges faced, the successes and gaps in the FSA's work, the FSA's relationship with its delivery partners and how the impact of the FSA's work can be measured. In order to reach the widest number of stakeholders possible, we also sent a qualitative questionnaire covering the same topics to members and former members of the FSA's working groups.

35 Consumer consultees

Consultees

- Which?
- National Consumer Council
- Resolution Foundation
- Personal Finance Education Group
- BBC
- Roehampton University
- Citizens Advice
- Omagh Independent Advisors
- Fairbridge West
- L&Q Housing Trust

11. Correspondence and monitoring of Adam Smith web log

28 We received 115 pieces of correspondence in relation to our review of the FSA. Many of these communications referred to matters which were outside our terms of reference. Where the information related to our terms of reference areas we treated the submissions as evidence to be investigated and considered alongside our other streams of evidence gathering.

29 The Adam Smith Institute set up a web log for people to post comments on our review. We monitored this web log and where comments were relevant to our terms of reference areas we treated them as evidence to be investigated and considered alongside our other streams of evidence gathering.

TERMS OF REFERENCE

1. Internal performance management

The FSA's economy and efficiency is kept under review, and reported on in the annual report, by its Non-Executive Directors. They are informed by, among other things, the FSA executive's quarterly management information and in particular the "Economy and Efficiency" reporting. The FSA is seeking continuously to enhance this economy and efficiency reporting and is implementing a complementary strategic performance management framework focused on effectiveness. In this context:

- how effective are the FSA's Non-Executive Directors in carrying out their responsibility to prepare an annual report on economy and efficiency, and are there any suggestions for improving their effectiveness?
- how useful to the Non-Executive Directors are the FSA's new "Economy and Efficiency Report" procedures, and are there any suggestions for improvement?
- how well is the FSA matching its resource allocation to its identification of risks to its objectives?
- are there any suggestions about the design of the FSA's new strategic performance framework?[149]
- are there any suggestions for improving the processes?

2. External joint-working within the UK

In the context of the Hampton Report and the benefits of risk-based regulation for efficient use of resources by regulators and the business sector:

- how strong are the links and working relationships between the FSA and other relevant regulatory bodies in the UK – notably The Pensions Regulator, the Financial Reporting Council and the Office of Fair Trading – and is the sharing of regulatory techniques and expertise between them effective?
- looking ahead, what are most likely to be the future priorities and challenges for joint-working with UK regulatory bodies, and are there any suggestions?

3. Influencing and representation internationally

A large proportion of financial regulation in the UK is based on international and/or EU standards or rules. The ability to supervise effectively and efficiently depends in part on these rules and standards. The FSA has, since its establishment, been given an important role in international fora. Its role in EU bodies has increased since the establishment of the so-called "level 3" committees of European supervisors. In that context:

- does the FSA's performance in influencing the development of international and EU financial supervision – in particular through its participation in international and EU bodies – reflect fully the UK's prominent role as a global financial market, and are there any suggestions for improving the FSA's performance in future?

4. Financial crime

The FSA has an objective relating to financial crime. It works with the Treasury, SOCA, the police and other bodies. In this context:

- is the FSA's work on combating financial crime effectively – including counter-terrorist finance – integrated with its other supervisory work and with other agencies in this field?
- is the FSA communicating effectively with business about issues on the financial crime agenda, and sharing information with them about risks?
- does the FSA make appropriate use of its enforcement powers and penalties?
- in light of the above, and the FSA's risk based allocation of its finite resources, does the level of resources allocated to combating financial crime – including counter-terrorist finance – appear appropriate, given its size and importance?

5. Financial capability

The FSA has an objective relating to public awareness. It has recently published an updated strategy on financial capability, having surveyed the extent of consumers' abilities. Lack of ability and understanding on the part of consumers remains one of the key underlying market failures in retail financial services, and as such one of the reasons for financial regulation. In this context:

- is the FSA's allocation of resources to work on financial capability appropriate (i.e. when looked at in the context of other demands on the FSA's finite resources and considering the cost/benefit of investment of resources in seeking to impact on this large scale social issue), bearing in mind the regulatory consequences and costs of low financial capability among consumers?
- how effective is the FSA's working with other organisations, in the public and private sectors, to improve financial capability – and are there any opportunities to increase value-for-money through partnership?

HM Treasury
June 2006

APPENDIX ONE

Performance management

This appendix contains information relating to key aspects of our review of the FSA's performance management, specifically:

a our benchmarking of the FSA's performance management framework against the NAO Efficiency Toolkit; and

b information relating to the FSA's Outcomes Performance Report showing an example of its lower levels.

1a. Benchmarking the FSA's performance management framework against NAO Efficiency Toolkit

1 The National Audit Office developed its Efficiency Toolkit in 2006. It provides practical guidance on assessing an organisation's current approach to achieving efficiency. It helps identify opportunities for improvements and develop actionable recommendations.

2 The National Audit Office applied the Performance Management assessment to the FSA's performance management system. It is essentially a performance management maturity model which describes how well an organisation's performance management capabilities link behaviour with business strategies.

3 The model describes five interlocking elements key to effective performance management:

- Strategic measures – Managing the business through financial and non-financial measures linked to strategy
- Cascaded measures – Strategic measures cascaded consistently down the organisation
- Aligned processes – Planning, budgeting, capital investment and appraisal and reward processes aligned consistently with business strategy
- Management Information – Reliable management information is available that supports the measures
- Action – Using the information to act appropriately to ensure the required target performance is met.

4 The toolkit divides each element into a spectrum of potential capabilities against which an organisation can be benchmarked. An informal high-level benchmarking exercise of the FSA's performance management system against these capabilities has been carried out with the following results:

- Strategic measures – The FSA scores highly in managing the business through strategic measures, largely due to the design of the Outcomes Performance Report (the Outcomes report) linking the Outcomes report to the strategic objectives. A possible area for improvement is understanding the inter-relationship between different measures (i.e. risk and resource).

- Cascaded Measures – The FSA scores medium-high for cascaded measures. The structure of the Outcomes report targets performance management at all levels onto the strategic aims. However, the culture embodied in the Outcomes report is not yet embedded and links with individuals/teams need to be strengthened (currently some teams may still use their own measures internally leading to inconsistencies). A particular area of weakness is that the FSA has a high number measures in use at different levels (many unrelated to the Outcomes report). This could lead to links with overall business requirements remaining unclear.
- Aligned processes – The FSA scores medium-high in aligning processes consistently with business strategy. Strengths include the alignment of planning and budgeting with strategic direction and the use of milestones. Areas for possible improvement include on-going assessments of the performance management system and strengthening the link with the reward framework.
- Management Information – The FSA scores medium-high in delivering reliable management information to support the measures. A particular strength is the governance arrangements surrounding data, including the "ownership" of the Outcomes report's indicators by directors. Areas for possible improvement include the co-ordination of data from different sources to allow more cross-reporting (e.g. between risks and resources) and more regular reporting of key measures to Executive Committee (i.e. monthly rather than quarterly).
- Action – The FSA scores medium in acting on management information. Given the volume of management information, there is a risk that the process of measurement could displace time from acting on the information. It is important to ensure that the focus of management remains on action rather than process.

5 Overall, the FSA scores highly indicating that it has a mature performance management framework linked to business strategies. This reflects the high profile of performance management at the FSA resulting from its statutory obligation to measure performance.

1b. The FSA's new Outcomes Performance Report

This section contains two figures illustrating the operation of the Outcomes Performance Report in greater depth.

The FSA has translated its statutory objectives into three strategic aims:

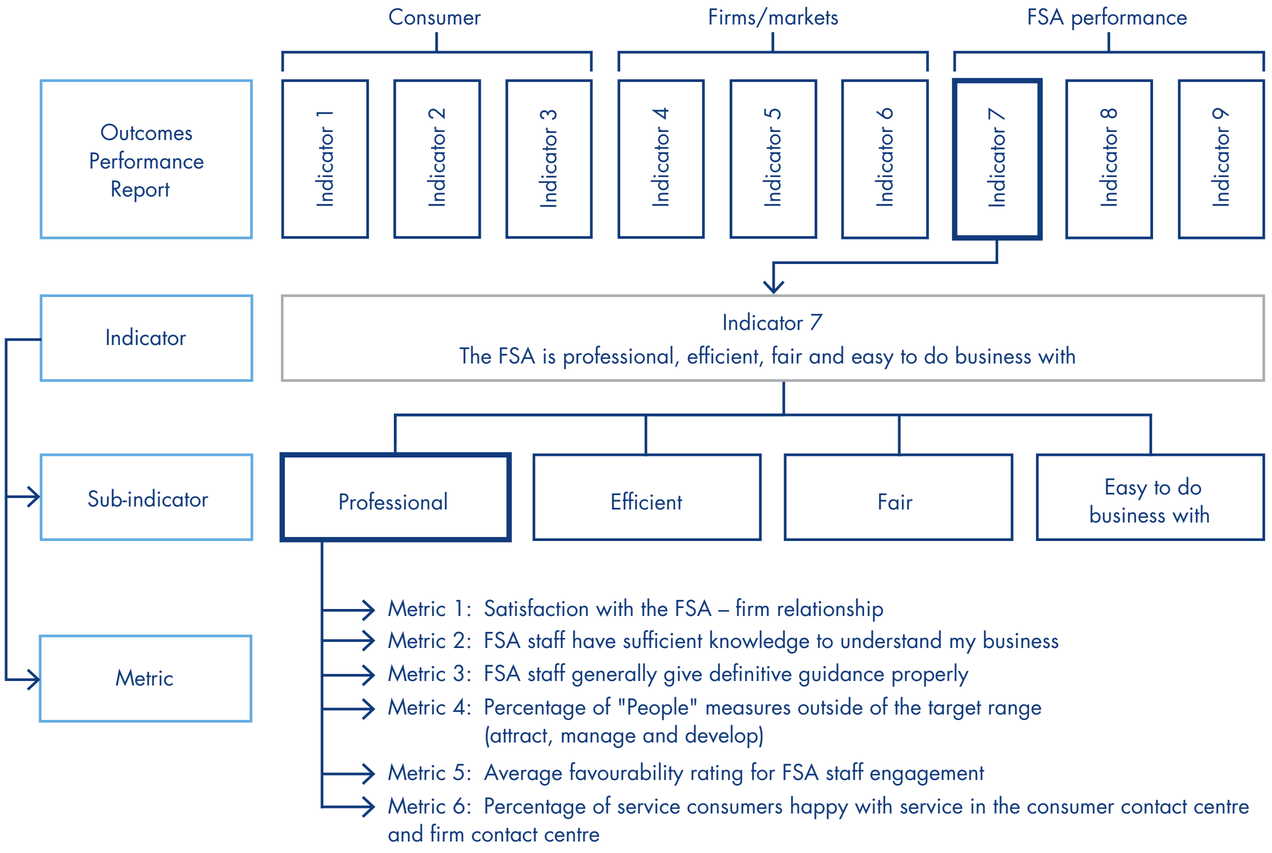
- Helping retail consumers achieve a fair deal
- Promoting efficient, orderly and fair markets
- Improving the FSA's business capability and effectiveness.

The Outcomes report has nine high level indicators by which to assess performance in achieving its strategic aims. These nine indicators are:

1. Consumers receive and use clear, simple and relevant information from the industry and from the FSA;
2. Consumers are capable of exercising responsibility when dealing with the financial services industry;
3. Financial services firms treat their customers fairly and thereby help them to meet their targets;
4. Firms are financially sound, well managed and compliant with their regulatory obligations;
5. Firms and other stakeholders understand their respective responsibilities and mitigate risks relating to financial crime and arising from market conduct;
6. Financial markets are efficient, resilient and internationally attractive;
7. The FSA is professional, fair and easy to do business with;
8. The FSA is effective in identifying and managing risks to its statutory objectives;
9. The costs and benefits of regulation are proportionate.

Each indicator is broken down into a number of sub-indicators which are in turn supported by a series of metrics. **Figure 36 overleaf** demonstrates this for indicator 7.

36 The lower levels of the Outcomes Performance Report



Source: FSA

APPENDIX TWO

Working with other regulators

This appendix includes information which further illustrates the working relationship between the FSA and the OFT, specifically:

a The FSA/OFT Joint Action Plan which sets out the key areas of collaboration between the two organisations.

2a. FSA/OFT Joint Action Plan

The key points from the FSA/OFT Joint Action Plan are set out below:

Working more closely together:

- The FSA and the OFT published studies in October 2006 on Payment Protection Insurance (PPI), and intend to collaborate on future regulation of this market.
- They updated a Concordat formalising their working arrangements on unfair contract terms.[150]

  This commits the FSA and the OFT to take necessary and proportionate action where there is evidence of a potential breach of the regulations causing consumer harm. It should ensure that there is no duplication of effort and that action is taken by the body best placed to lead on any given issue.
- Implications of the new Consumer Credit Act 2006 for the Financial Ombudsman Service.

  The OFT is responsible for regulating consumer credit. The new Consumer Credit Act creates the Consumer Credit Jurisdiction (CCJ), which allows consumers to access the Financial Ombudsman Service (FOS) for consumer credit complaints concerning firms that are licensed by the OFT but not authorised by the FSA. The FSA and FOS worked with the OFT to align the CCJ with the existing FOS Compulsory Jurisdiction (CJ), resulting in changes to the relevant FSA Handbooks. The FSA will be responsible for the way FSA-authorised firms handle all complaints, including those concerning consumer credit business, so jointly regulated firms' complaint handling procedures will be overseen by one regulator only. This also means that FSA-authorised firms will only pay a single levy to fund the FOS rather than two separate levies. These changes will be brought into effect in April 2007.

Reducing the administrative burden on jointly regulated firms:

- Consolidated guidance and revised rules on jointly regulated advertisements.
- Completed feasibility studies into ways to reduce the burden on jointly regulated firms in respect of the FSA and OFT's authorisation and licensing processes. Studies concluded that few changes were justified on cost-benefit grounds at this time but agreed to revisit these results once new on-line systems are in place. These findings were endorsed by the industry user group for the Joint Action Plan.
- New joint communications strategy agreed.

Communicating with consumers

- Re-launch of the FSA and the OFT's consumer websites and improved coordination of consumer communications

  Collaboration continuing between the FSA and the OFT on a revamp of their respective websites and consumer communications strategy. The FSA and OFT will share lessons from the respective work and campaigns and feed them in to future campaign planning and evaluation. This will include using regional data from the FSA's Financial Capability Baseline Survey.
- Consumer contact centres

  Collaboration continuing on the feasibility of integrating their consumer contact centres.
- Public registers

  Collaboration continuing on the feasibility of integrating the FSA's and the OFT's public registers. The study is due to be completed by the end of March 2007.

APPENDIX THREE

Influencing and representation internationally

This appendix sets out further information on the European context in which the FSA operates, specifically:

a The relationship between key EU institutions and the Lamfalussy committees.

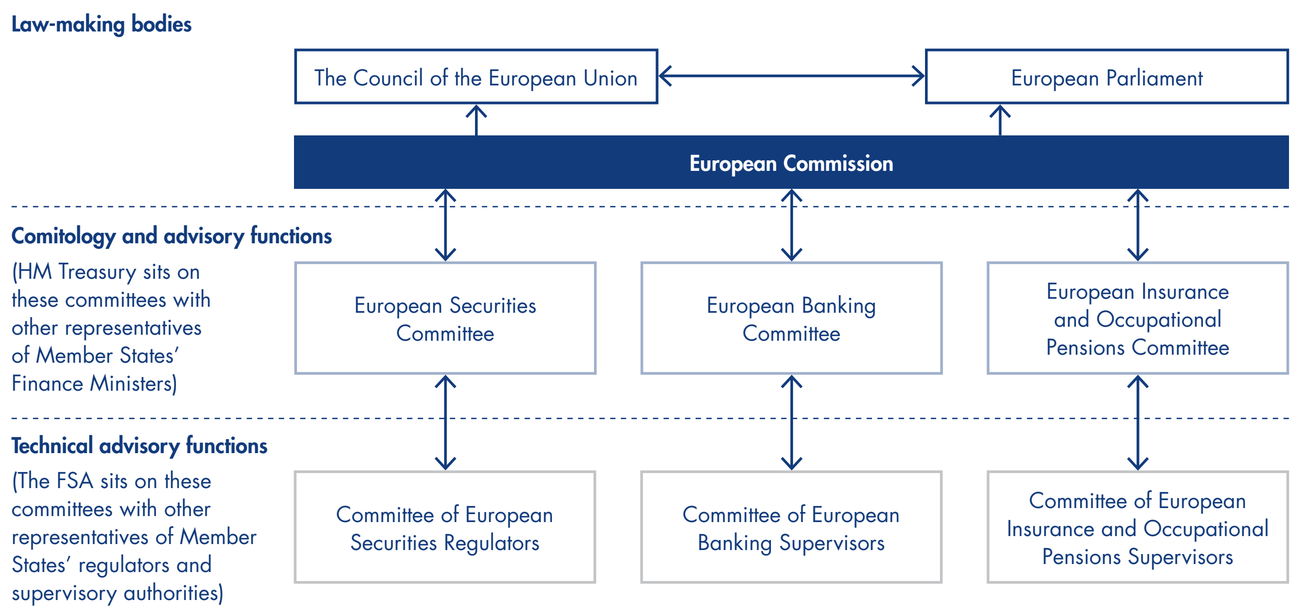
b The respective roles of the FSA and HM Treasury in influencing EU policy development.

c The most significant EU legislative measures currently being implemented or under development.

3a. EU institutions and the Lamfalussy committees

The financial architecture of regulation in Europe is characterised by de-centralisation with separate national regulators rather than a centralised single European regulator; segmentation with specialist committees that cover distinct financial activities (banking; securities; insurance and occupational pensions); and co-operation between national regulators who sit on these committees.

37 The relationship between the Lamfalussy committees and other key EU institutions



Source: National Audit Office

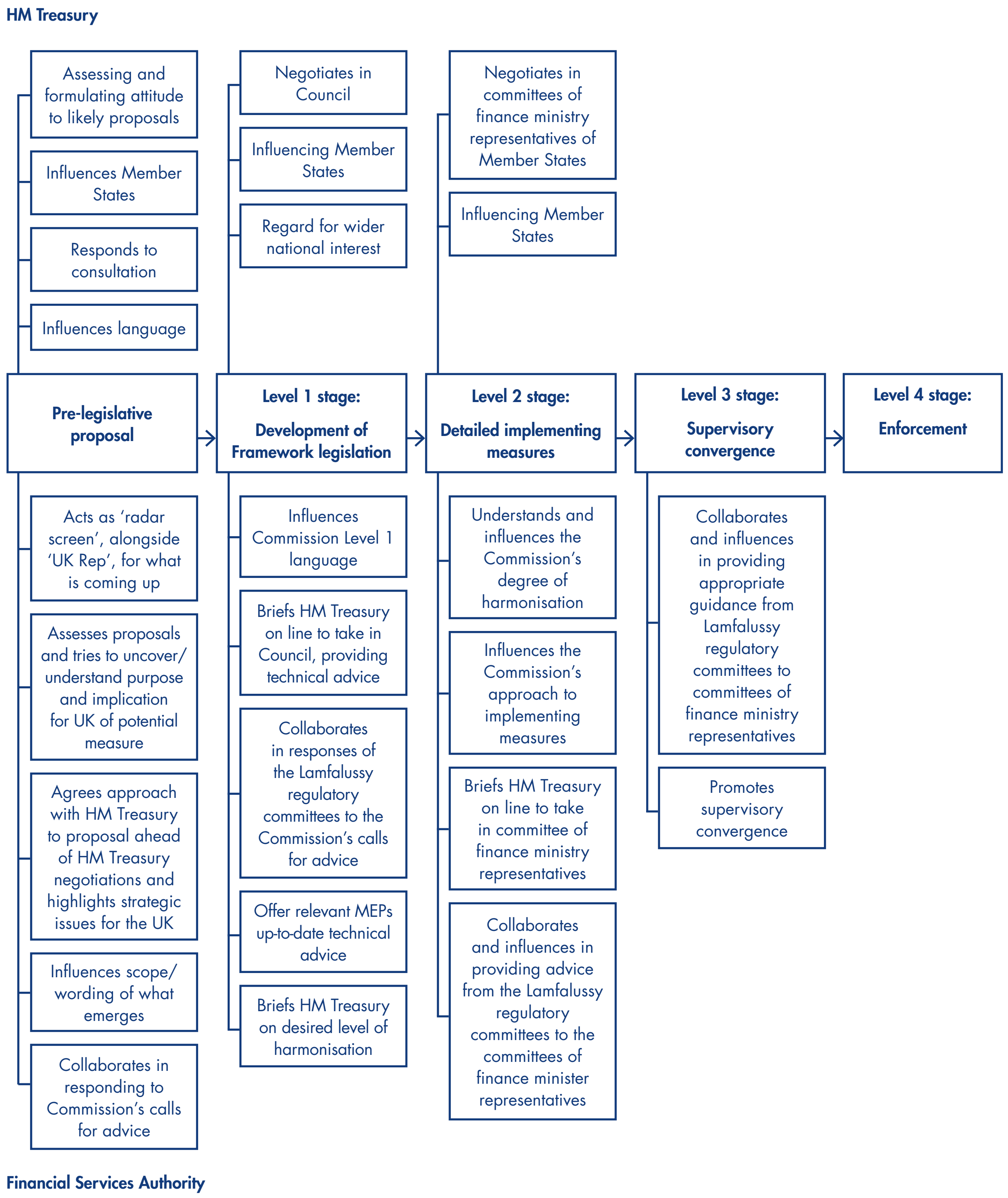
NOTE

This is a simplified schematic to show where the committees of regulators (including the FSA) and the committees of finance ministers' representatives (including HM Treasury) sit in relation to other key legislative bodies in Europe. The committees are known as the Lamfalussy committees.

3b. The FSA/Treasury in EU policy development

As explained in part 3 the FSA and HM Treasury both have roles to influence and represent at European Union level. **Figure 38** sets out their respective roles in influencing EU policy development.

38 The respective roles of the FSA and HM Treasury in influencing EU policy development



Source: FSA

3c. The most significant EU legislative measures currently being implemented or under development

- **Capital Requirements Directive:**

  This Directive introduces a risk-sensitive prudential framework for credit institutions and investment firms across the EU. It applies to all investment firms, banks and building societies. It is closely linked to the Revised Basel Framework, agreed in June 2004, which applies to internationally-active banks.

- **Markets in Financial Instruments Directive:**

  MIFID is a wide-ranging Directive, constituting a major element in the EU's Financial Services Action Plan. The Directive substantially revises the current Investment Services Directive and is intended to promote a single market for wholesale and retail transactions in financial instruments. MIFID widens both the scope of investment services requiring authorisation by Member States and the range of investments falling within the range of regulation. In relation to these and other investment services and activities, MIFID significantly improves the 'passport' for investment firms. This enables them to conduct cross-border activities across Europe on the basis of their Home State authorisation.

- **Reinsurance Directive:**

  The Reinsurance Directive (RID) aims to introduce harmonised supervision of reinsurance across the EU. It is intended to create a single market in reinsurance (similar to that which already exists for direct insurance) and to remove remaining barriers to trade within the EU.

- **Third Money Laundering Directive:**

  The main purpose of the Directive is to provide a common EU basis for implementing the revised Financial Action Task Force (FATF) recommendations (issued in June 2003). It will replace the First and Second Money Laundering Directives.

- **Transparency Directive:**

  The Transparency Directive (TD) establishes periodic reporting requirements on an ongoing basis for issuers who have securities admitted to trading on a regulated market situated or operated within the EU. Investors in shares of issuers listed on regulated or prescribed markets will need to comply with major shareholding disclosure rules.

- **Unfair Commercial Practices Directive:**

  The Unfair Commercial Practices Directive (UCPD) seeks to protect consumer interests from unfair business-to-consumer commercial practices. In particular, commercial practices will be unfair if they are misleading (this includes both acts and omissions) or aggressive. The Directive contains a list of 31 practices which will always be considered unfair.

- **Regulation on information accompanying wire transfers:**

  The Regulation seeks to adopt into EU legislation FATF Special Recommendation VII on information accompanying wire transfers. The requirement is for transfers of funds to be accompanied by accurate and meaningful originator information. Financial institutions will be required to monitor incoming transfers and to detect those without full originator information.

- **Solvency 2:**

  Solvency 2 is a fundamental and wide-ranging review of the current EU Life and Non-Life, Reinsurance and Insurance Groups Directives (Solvency 1) in the light of developments in insurance, risk management and finance techniques.

- **Credit for Consumers Directive:**

  The purpose of the Credit for Consumers Directive is to promote the development of a Single Market for consumer credit. It will apply to all providers of unsecured credit to consumers (such as banks and building societies), and all unsecured credit intermediaries.

- **Payment Services Directive:**

  The aim of the Directive is for users to be able to make cross-border payments as quickly, efficiently and securely as they can. The proposed Directive introduces conduct of business regulation for all payment service providers and an authorisation regime for providers that are neither currently authorised as credit institutions nor e-money issuers – creating a new class of 'payment institutions' (e.g. money remitters).

APPENDIX FOUR

Financial Crime

This section provides further information on the FSA's work on the complex area of financial crime and the NAO's work to assess the FSA's performance in this area, specifically:

- a **An explanation of the Money Laundering Offence;**
- b **How the FSA will measure its performance on financial crime through its Outcomes Performance Report; and**
- c **Summary results from the NAO survey of FSA supervisors on the questions relating to financial crime.**

4a. Money Laundering

This section provides an explanation of the Money Laundering Offence, including a definition, the relevant legislation, the controls required for firms and the differences between Money Laundering and Counter-Terrorist Financing **(see Figure 39 overleaf)**.

4b. Performance measurement in financial crime work

This section demonstrates how the Outcomes Performance Report measures the FSA's performance on financial crime, from the high level indicator down to the 18 metrics **(see Figure 40 on page 79)**.

4c. National Audit Office survey of FSA supervisors

This section contains summary results from the NAO survey of FSA supervisors on questions relating to financial crime. We have set out both quantitative results and qualitative comments by the supervisors **(see Figures 41 and 42 on page 80)**.

39 Explaining the Money Laundering Offence

Change	Issue
Definition	The ways in which criminals process illegal or "dirty" money derived from the proceeds of illegal activity (e.g. drug-dealing, human trafficking, fraud, tax evasion) through a succession of transfers/deals until the source of illegally acquired funds is obscured and the money takes on the appearance of legitimate or "clean" funds
Relevant legislation	Terrorism Act 2000 Proceeds of Crime Act 2002 Money Laundering Regulations 2003 Serious Organised Crime and Police Act 2005 The Proceeds of Crime Act 2002 and Money Laundering Regulations 2003 (Amendment) Order 2006 EU 3rd Money Laundering Directive 2005 (implemented in UK by 15 December 2007)
Money Laundering Offence	■ trying to turn money raised through criminal activity into 'clean' money; ■ handling the benefit of acquisitive crimes such as theft, fraud and tax evasion; ■ handling stolen goods; ■ being directly involved in, or entering into arrangements to facilitate laundering; and ■ criminals investing the proceeds of their crimes in the range of financial products.
Controls required for firms	There are three broad groups of offences that firms need to avoid committing: ■ knowingly assisting in concealing, or entering into arrangements for the acquisition, use, and/or possession of, criminal property; ■ failing to report knowledge, suspicion, or where there are reasonable grounds for knowing or suspecting, that another person is engaged in money laundering; and ■ tipping off, or prejudicing an investigation. It is also a separate offence under the ML Regulations not to have systems and procedures in place to combat money laundering (regardless of whether or not money laundering actually takes place).
Sectors involved	■ Financial services ■ Money Service Businesses ■ High Value Dealers (e.g. jewellers) ■ Real estate agents ■ Accountants, Trust and Company Services ■ Lawyers
Differences with counter terrorist financing	■ often only small amounts are required to commit individual terrorist acts, thus increasing the difficulty of tracking the terrorist property; ■ terrorists can be funded from legitimately obtained income, including charitable donations, and it is extremely difficult to identify the stage at which legitimate funds become terrorist property.

Source: HM Treasury[1] and Joint Money Laundering Steering Group[2]

NOTES

1 HM Treasury (2004), "Anti-Money Laundering Strategy", October 2004 (http://www.hm-treasury.gov.uk/media/D57/97/D579755E-BCDC-D4B3-19632628BD485787.pdf). 3rd Money Laundering Directive brings in further requirements for supervision with these sectors coming under the Money Laundering regime.

2 Joint Money Laundering Steering Group (2006), "Prevention of money laundering/combating the financing of terrorism" (http://www.jmlsg.org.uk/content/1/c4/68/86/Final_Part_I_030306.pdf).

40 Monitoring financial crime in the Outcomes Performance Report

Consumers			Firms/Markets			FSA performance		
1	2	3	4	5	6	7	8	9

Indicator 5: Firms and other stakeholders understand their respective responsibilities and mitigate risks relating to financial crime and arising from market conduct.

Firms understand and mitigate risks relating to financial crime

1. Survey of firms[1] (level of resources and understanding)
2. Survey of firms (verification of staff criminal disclosures)
3. Number of Suspicious Activity Reports submitted to Serious and Organised Crime Agency by regulated firms
4. Number of small firm alerts for financial crime

The FSA acts to mitigate risks relating to financial crime

5. Survey of firms about FSA as an effective partner and its communications
6. Survey of firms about its communications
7. Authorisations/ permissions rejected ('gatekeeper' role)
8. Staff having passed financial crime training
9. Number of reports on financial crime to internal committee
10. Number of financial crime cases referred to Enforcement

Other stakeholders understand their respective responsibilities and mitigate risks relating to financial crime

11. Survey of firms about stakeholder capabilities
12. Number of cases of information exchange
13. Number of significant fraud trials

Recorded levels of financial crime and market abuse

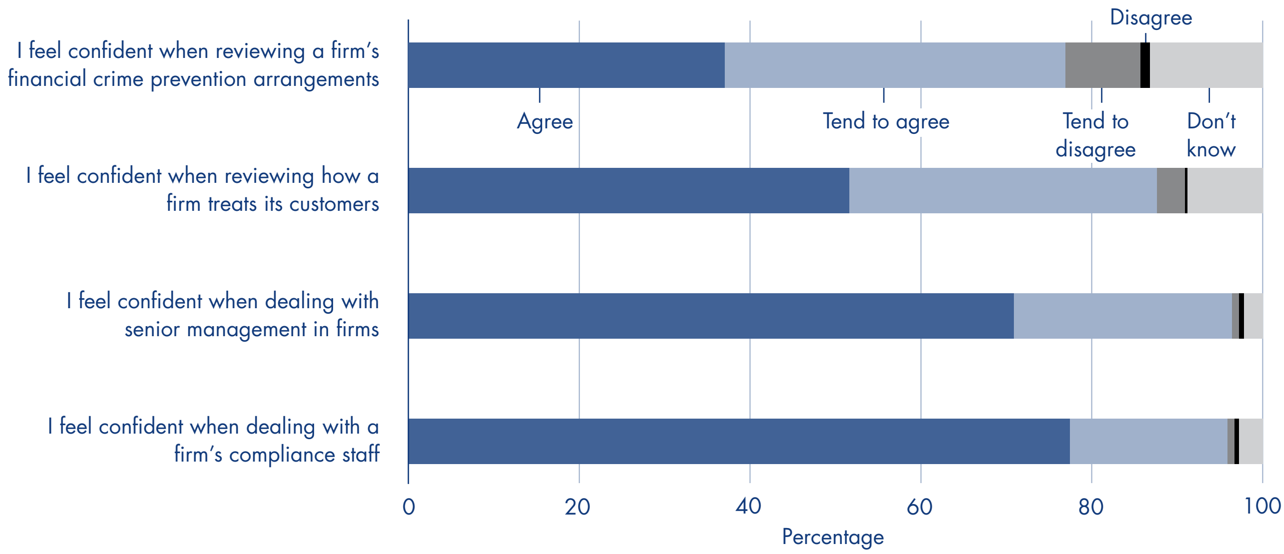
14. Survey of Money Laundering Reporting Officers' views
15. Number of fraud trials
16. Measures of market cleanliness
17. Related consumer enquiries to FSA
18. Press coverage (is it positive towards financial crime work?)

Source: FSA

NOTE

1 The FSA is planning to undertake an annual Financial Crime Survey of firms. It will ask senior management and Money Laundering Reporting Officers about their perceptions of crime and the firm's approach to countering financial crime, including level of resourcing.

41 Supervisors interacting with firms



Source: National Audit Office survey of Financial Services Authority supervisors

42 Selection of comments from supervisors on approach to financial crime

Issue	Responses
Strategic approach	"The financial crime sector team come across as being very pro-active" "The interplay between the financial crime [sector] team's work and that in the Markets Division on tackling market abuse is not clear"
Profile of financial crime	"Financial crime training has only been developed very recently. Previously the area was largely invisible to most people" "Financial crime seems to have taken a back seat to ARROW 2 development and it's unclear to most staff how financial crime work fits with ARROW 2" "I note a lack of understanding of financial crime… needs more attention" "… focused on firms [with] compliance resources and could do more for the sole trader"
Weight accorded to financial crime in supervision	"My impression is that, as supervisors, financial crime is secondary to our role of protecting customers" "I always felt financial crime could be better represented in supervision as many supervisors are unsure what to ask with regards to… their firm" "[The] overwhelming focus is TCF not financial crime" "Where there is more than 1 supervisor working on a firm it may not be necessary for all supervisors to be equally expert on all issues"
Training and development	"It needs to be more practical… haven't had any proper training on the new guidance" "Training has to be tailored to the different types of firms being supervised" "more practical training in how to put the information into practice with small firms" "…. relating to JMLSG's revised risk based approach, in-house guidance has been at a "high level" and not very detailed"

Source: National Audit Office survey of FSA supervisors

APPENDIX FIVE

Financial Capability

This section provides further information on the FSA's work on financial capability and the NAO's review of its performance in this area, specifically:

- **a** **The FSA's intended outcomes for its National Strategy for Financial Capability.**
- **b** **The range of intermediate and final targets which the FSA has set out for each of its financial capability projects.**
- **c** **An outline of how financial capability relates to the FSA's retail strategy and wider strategic aims.**
- **d** **Treating Customers Fairly.**

5a. Intended outcomes for the National Strategy for Financial Capability

This section sets out the FSA's planned overall outcomes for its work on Financial Capability, first set out in *Building Financial Capability in the UK* in March 2005. The outcomes are set out in four themes – working together; reaching people; influencing people and making a difference.

43 Planned outcomes for the National Strategy on Financial Capability

Working Together	Support for the strategy is established among key partners (consumer groups, voluntary groups, Government and the financial services industry) Funding and other resources are put in place Resources spent on financial capability projects are better coordinated and spent more efficiently Financial capability projects are given significantly greater priority
Reaching people	There is a step change in the number of people who are reached by financial capability initiatives People are reached in ways which are more suited to their needs People actively looking for help are offered simpler access to it, appropriate to their needs
Influencing people	Skills: People have more of the skills needed to address personal finance issues Knowledge and understanding: People have greater knowledge and understanding of financial issues, can better identify their needs and the products that might help meet those needs, and know when and where to seek further advice Awareness: People are more aware of the need to take control of their personal finances Confidence: People have greater confidence in their ability to take an active role in managing their financial needs Engagement: People are engaged and motivated to take action
Making a difference	More people review their financial situation regularly People are more discriminating when shopping for financial services Fewer people buy unsuitable financial services and products The FSA is able to take a less interventionist approach to the regulation of the retail financial services industry The financial services industry designs products that more closely meet people's needs Products are promoted and sold in a fashion that is more suited to people's needs

Source: FSA

5b. Targets for Financial Capability Projects

Figure 44 sets out the FSA's intermediate and overall targets for its financial capability projects between 2006 and 2011, set out in the FSA's annual report 2005-06.

44 Intermediate and overall targets for the FSA's Financial Capability projects

Key outcome/indicator: To provide a step change in the financial capability of the UK population	Intermediate Targets 2006-07	Overall Targets for 2006-11
Schools (Learning Money Matters) ■ To create effective partnerships in a coherent and funded strategy to deliver Learning Money Matters in schools. ■ Support made available through this project is used by teachers of children in the 11–19 age range. ■ The profile, status and quality of personal finance education (pfe) is raised and maintained. ■ Young people agree that the pfe they receive at school has made them more capable and confident in dealing with financial issues.	■ Establish UK co-coordinating group to oversee implementation of Learning Money Matters across UK. ■ Develop and implement longer-term funding strategy. ■ 500 secondary schools request support through Learning Money Matters. ■ 75,000 new pupils in the 11–19 age reached by project. ■ Planned changes to the curriculum in England and N. Ireland already provide the opportunities to mainstream pfe in these countries. The FSA will contribute to the curriculum reviews currently taking place in Wales and Scotland to assist in mainstreaming pfe in these countries too. ■ Deliver a toolkit that will enable schools to evaluate the impact of pfe on the confidence of young people to deal with financial issues.	■ Key stakeholders such as Department for Education and Skills and Qualifications and Curriculum Authority remain fully engaged with schools project. ■ Project is fully funded. ■ 4,000 secondary schools in England have accessed and used support through Learning Money Matters. ■ 1.8 million pupils in 11–19 age range reached by project. ■ Most schools recognize the importance of pfe and include it within their curriculum development plans. ■ Evaluation demonstrates that young people are more confident and better equipped to deal with financial issues.
Young Adults: Helping Young Adults Make Sense of Money (Higher Education, Further Education & those Not in Education, Employment or Training) ■ To create effective partnerships in a coherent and funded delivery strategy to young adults in Higher Education, Further Education and NEET (those Not in Education, Employment or Training). ■ Delivery organisations commit sufficient resources to the programme. ■ The products and support promoted through the Young Adults programme (toolkits and training) are used by delivery organisations in order to reach the target audiences. ■ Young adults in target sectors engage with the need to take control of their money and agree that the programme has helped them to be more capable and confident in dealing with financial issues.	Higher Education Institutions ■ 10–20 representative HE Institutions across the UK become "Early Adopters". ■ Early Adopters refine and add to the model developed in partnership with Roehampton University ("Money Doctors" scheme) and provide appropriate evaluation and feedback (Q3 2007). ■ Refined and enlarged toolkit is completed in two stages and available for national roll-out in academic year 2007-08. Further Education Institutions ■ Work with FE Institutions, Learning and Skills Councils and their umbrella bodies to use personal finance as a context for delivering key skills. This will be based on successful pilots in London colleges. ■ Adapted Roehampton University (Money Doctors) pilot package taken up and used for pastoral support by five FE Institutions (during academic year 2006-07).	■ All 168 UK HE Institutions are aware of, and use, the toolkits and training available and proactively provide their students (currently 2.3 million) with information, education and guidance about their personal finances. ■ Evaluation demonstrates that students are more confident and better equipped to deal with financial issues. ■ All UK FE institutions – serving an estimated five million students – will be aware that personal finance can be used as a context for delivering key skills. 25 per cent of colleges do so. ■ Evaluation demonstrates that students are more confident and better equipped to deal with financial issues.

44 Intermediate and overall targets for the FSA's Financial Capability projects *continued*

Key outcome/indicator: To provide a step change in the financial capability of the UK population	**Intermediate Targets 2006-07**	**Overall Targets for 2006-11**
Young Adults: Helping Young Adults Make Sense of Money (Higher Education, Further Education & those Not in Education, Employment or Training) *continued*	NEET Sector ■ First tranche (10-12) of organizations to act as Early Adopters identified and programme agreed. ■ Second tranche (50) early Adopters confirmed. ■ Training and evaluation of second tranche on track to complete at end May '07. ■ On track for Early Adopter showcase event and report publication in Q4 2007.	■ Major government and charitable/voluntary sector organizations providing services to 1.1 million young people across the UK in the NEET sector are aware of the toolkits, training and quality materials available on financial capability, and the majority routinely provide such training to their staff. ■ Policy-making bodies support the programme and participate in its development. ■ Evaluation demonstrates that young people in the NEET sector are more confident and better equipped to deal with financial issues.
	Infrastructure ■ Establish whether there is a business case for providing support to organisations in the form of a national 'phone line and web-based information service and/or local partnership networks. ■ Fully costed business case for 'phone line and web-based information service prepared. ■ Explore further funding and operational possibilities for 'phone line and web-based information service. ■ Decide whether to proceed with 'phone line.	■ Dependent on business case investigation and result of continuing pilot at Young Scot. Possibly a national 'phone information service for young adults.
Workplace: Make the Most of your Money ■ Win commitment of adequate resource from partner organizations in the financial services industry and elsewhere. ■ Employers in the public and private sectors agree to participate in the programme, are convinced of the value of the programme and want to remain involved. ■ Employees make effective use of materials. ■ Employees attend seminars and adapt behaviour as a result. ■ Improved financial capability of employees reached.	■ 200,000 employees receive the 'Make the most of your money' information booklet. ■ 15,000 employees attend a one-hour generic advice seminar.	■ 4 million people receive financial information. ■ 500,000 attend a seminar. ■ Evaluation demonstrates that employees are more confident and better equipped to deal with financial issues, and that employers and seminar presenters derive anticipated benefits.

44 Intermediate and overall targets for the FSA's Financial Capability projects *continued*

Key outcome/indicator: To provide a step change in the financial capability of the UK population	**Intermediate Targets 2006-07**	**Overall Targets for 2006-11**
Workplace: Make the Most of your Money *continued* ■ Methods of delivering financial education in the workplace, and the materials provided, evolve to reflect the differing needs of employers. ■ The programme adapts to new initiatives, such as the introduction of a National Pension Savings Scheme.		
Consumer Communications ■ Effective partnerships with third parties who will help deliver financial capability products/services to the right people at the right time. ■ Clarity about target audiences FSA is trying to reach (influenced by the Financial Capability survey). ■ Information is engaging, accessible and appealing. ■ Significantly increased awareness and understanding among target audiences of FSA as a provider of free, impartial information. ■ Close collaboration with the Office of Fair Trading (OFT) on debt issues.	■ Increase the number of third parties who link to the FSA website. ■ Target audiences (for overhaul of website and publications) agreed using results of the Financial Capability Survey and other relevant inputs. ■ Core consumer messages are consumer tested, revised and agreed. ■ Consumer website overhauled by end Q4 2006, in collaboration with the OFT's revamp of its website. ■ New visual identity for consumer-facing material developed and tested. Rolled out on website in Q4. ■ Forward plan for consumer campaigns is developed. ■ Partnerships with key organizations are built to support campaigns. ■ Consumer testing of online material and selected publications, with recommendations fed into redevelopment project.	■ Traffic to new consumer website doubles over next three years – from 2 to 4 million per annum. ■ Deeper and more effective partnerships with third parties which enable us to reach our target audiences on key issues. ■ The majority of target audiences regard the FSA as a valuable source of impartial information on financial products and services (specific targets will be set for individual campaigns). ■ Evaluation demonstrates that consumers using the FSA's information demonstrate improved financially capable skills/behaviours. ■ Publications overhauled by Q2 2007.
Online Tools ■ FSA is working with and has the support of stakeholders to make its online tools more widely available. ■ FSA online tools are increasingly used by others. ■ Consumers using FSA online tools have more confidence and feel more capable about managing their affairs. ■ Consumers using FSA online tools behave differently when managing their financial affairs (e.g. plan better and make informed choices).	■ *(This phase will test the syndication model with a variety of partner types.)* ■ Increase the number of websites making available FSA online tools. 100 per cent increase in number of monthly visitors to FSA online tools, in particular the Healthcheck and Debt Test. ■ Use results to set suitable targets going forward for partner websites and visitor levels to online tools.	■ A significant increase in the number of websites making available FSA online tools. The long-term aim is to engage as many appropriate and high traffic partners as possible. ■ A significant increase in the number of visitors to FSA online tools.

44 Intermediate and overall targets for the FSA's Financial Capability projects *continued*

Key outcome/indicator: To provide a step change in the financial capability of the UK population	**Intermediate Targets 2006-07**	**Overall Targets for 2006-11**
New Parents (Money Box) ■ Establish whether or not a business case is made for proceeding with full rollout of Money Box. ■ Potential partners and distributors are identified. ■ If a business case is made, the product reaches target audience and parents are more aware of the financial implications of parenthood and more confident in managing their personal finances.	■ Develop and trial the concept through a number of large employers. ■ Obtain a full evaluation of the trial. ■ Assess the feasibility of using other distribution channels. ■ Develop the business case for full roll-out in 2007-08. ■ Involve key stakeholders and delivery channels.	■ If evaluation shows concept works, then by 2010-11 the product will have reached over 1.5 million parents. ■ A research and evaluation programme will show that new parents are more confident and better equipped to deal with financial issues.
Money Advice ■ Consumers become increasingly engaged with their own personal finances. ■ Preventative general money advice (recognisably distinct from the regulated sales process) is perceived as worthwhile and valuable. ■ Preventative general money advice is more widely available through a variety of channels appropriate to the target consumer audience. ■ There is a focus on groups with lower financial capability who could benefit most from access to preventative general money advice.	■ Positive engagement with prospective partner organizations (including governmental organisations and not-for-profit agencies) who have suitable infrastructure and relationships with people and are already providing advice and guidance in complementary subject areas. ■ Establish whether capacity exists for such organizations to provide preventative general money advice. ■ Completion of the assessment of whether it is in the interest of commercial organisations to offer non-regulated money advice.	■ The FSA is not yet in a position to formulate overall longer term targets, but will do so as soon is this initiative is sufficiently developed.

Source: FSA

5c. Financial capability work within the FSA and Retail Themes context

Figure 45 shows how the National Strategy for Financial Capability fits into the FSA's retail strategy, strategic aims and statutory objectives.

45 Financial Capability within the FSA

Statutory objectives

- Market confidence
- **Public awareness: promoting public understanding of the financial system**
- The protection of consumers
- The reduction of financial crime

Strategic aims

- Promoting efficient, orderly and fair markets
- **Helping retail consumers get a fair deal**
- Improving our business capability and effectiveness

Retail strategy

- **Capable and confident consumers**
- Clear, simple and understandable information from the industry and the FSA, available for, and used by, consumers
- Responsible firms who treat their customers fairly and are soundly managed and adequately capitalised
- Risk-based regulation, through firm-specific and thematic supervision and policy

National Strategy for Financial Capability (for planned outcomes see appendix 5a)

- Schools
- Young Adults
- Workplace
- Consumer Communications
- Online tools
- New parents
- Money Advice
- Innovation Fund

For project targets see Appendix 5b

Outcomes Performance Report Indicators

- Consumers receive and use clear, simple and relevant information from the industry and from the FSA
- **Consumers are capable in exercising responsibility when dealing with the financial services industry**
- Financial services firms treat their customers fairly and thereby help them to meet their needs

Sub indicators for Indicator 2	Metrics for sub-indicators
Consumers are capable regarding money management	Percentage of consumers deemed capable at money management in analysis of Financial Capability Survey
	Percentage of consumers deemed able to 'exercise responsibility' for money management in analysis of Financial Capability Survey
Consumers are capable when planning ahead	Percentage of consumers who are deemed capable of planning ahead in analysis of Financial Capability Survey
Consumers are capable at using financial products	Percentage of consumers who are deemed capable at using financial products in analysis of Financial Capability Survey
Consumers are capable when seeking and using advice	Percentage of consumers deemed capable when seeking and using advice and information in analysis of Financial Capability Survey
	If possible, the percentage of sample transactions in which there was an element of mis-buying of finanical products by the consumer from the Consumer Purchasing Outcomes Survey

Source: FSA

5d. Treating Customers Fairly

One of the FSA's 11 Principles for Business requires a financial services firm to pay due regard to the interests of its customers and treat them fairly. However, the FSA's supervisory work repeatedly uncovers problems in the way in which consumers are treated on a scale that it feels warrants serious thought and a determination to deliver change. The Treating Customers Fairly initiative, designed to encourage firms' senior management to direct their attention to ensuring the fair treatment of consumers, is an early example of the FSA's attempt to move to a more principles based approach to regulation.

Based on the FSA's 'product life-cycle' Treating Customers Fairly aims to achieve six outcomes for consumers. These outcomes are not FSA rules in themselves but designed as a description of the characteristics the FSA thinks a retail market will have if customers are to be treated fairly. They are:

- Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- Where consumers receive advice, the advice is suitable and reflect their needs, priorities and circumstances.
- 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 as they have been led to expect.
- Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

The FSA has said it expects to see that:

- a firm has considered the implications of TCF for its business;
- senior management have played the role we expect of them in relation to TCF – e.g. identifying risks, having appropriate systems and controls in place to mitigate these risks, and ensuring these are effective;
- a firm has made a genuine attempt to deliver on what TCF means for it; and
- there has not been significant actual – or risk of – consumer detriment.

APPENDIX SIX

Suggestions for implementing NAO recommendations on financial crime and financial capability

Financial Crime and Financial Capability are the two areas in our terms of reference that link most closely to a specific statutory objective of the FSA (reducing financial crime and improving public understanding of the financial system respectively). We have made a number of recommendations to the FSA on these areas. During our review, through our stakeholder interviews, data analysis and wider research we also developed a number of suggestions which could help the FSA to implement our recommendations. These suggestions are set out in the table below.

Terms of Reference Area	NAO recommendation	Supporting suggestions and ideas for implementation
Financial Crime	The FSA's new Financial Crime Directorate should keep supervisory staff fully informed of, and help them develop their expertise in financial crime issues.	■ Within its new directorate the FSA could place particular emphasis on ensuring better linkages between the two arms of intelligence gathering and analysis: the Intelligence Team and the Market Monitoring Department. ■ The increased profile of the new directorate can be used to assist staff in developing their expertise of financial crime issues – for example by providing training for supervisors which is more practical and better tailored to sector or firm size. ■ The FSA needs to ensure that its training – for example its presentations on how staff should use the Joint Money Laundering Steering Group Guidance – reaches as wide a population as possible. ■ The new directorate could push the FSA to consider whether it is possible for research to benchmark the FSA's financial crime enforcement work against international peers to allow it to better understand what suitable enforcement goals they could establish in terms of case types, throughput, timescales and even staffing of the enforcement function. ■ The Directorate could work with others at the FSA to encourage other regulators to publish outcome-focused market measurements so that it can determine suitable comparators.
	The FSA should examine the basis of its risk assessments to determine if it is appropriate to use size as a proxy for impact in financial crime and if greater weight should be given to smaller firms than at present.	■ The FSA could look at the approach of HM Revenue & Customs to money laundering supervision of Money Service Businesses and High Value Dealers to see if there are any lessons it can learn from HMRC's specialised risk assessment and program of visits for its own financial crime work. ■ The FSA could begin to include a number of financial crime related checks within its computerised checking of firms' self assessment reports. ■ The FSA could increase its financial crime education efforts with small firms – particularly providing more practical feedback on what a risk-based regime means in practice for example through peer benchmarking or worked examples.

Terms of Reference Area	NAO recommendation	Supporting suggestions and ideas for implementation
Financial Capability	The FSA should aim to quantify the costs to society and the financial services market of low levels of financial capability to help determine long term plans for its role and resource allocation for this problem. It should also set measurable goals for improvements in consumer behaviour and outcomes against which success can be judged.	■ Objectives could be developed jointly with HM Treasury. ■ Overall objectives could be set against the baseline survey or against national statistics measures such as savings rates or household debt. ■ Project targets could be set against the baseline survey, against other national measures, against organisational statistics – for example the number of students dropping out of university due to debt – or against the circumstances of participants. ■ The FSA may want to consult with marketing and social marketing professionals on developing measurable objectives. ■ Longitudinal research is particularly important for tracking impact on behaviour. ■ The FSA will need to ensure the information it is collecting at the start of its projects is suitable for evaluation – for example it could ask workplace seminar participants questions about current spending, saving and purchasing habits and ask the same questions at a later date to judge if behaviour has changed, although achieving meaningful response rates will be difficult. Employers will also hold data such as pension contributions which can be compared before and after workplace seminars. ■ The FSA could select control groups for its research – for example it could gather statistics on debt, saving etc from universities at which Money Doctors is being carried out and those at which it is not and compare changes over time. ■ Qualitative research to determine impact is also valuable, particularly in determining which elements of the projects had most impact on behaviour. ■ The FSA could consider developing its audience segmentation to include more behavioural and attitudinal characteristics as well as demographic and socio-economic. ■ The methodologies of the FSA's impressive work on the Financial Capability survey, the Consumer Purchasing Outcomes Survey and its other consumer research should be complementary and linkages between the findings, analysis and conclusions fully exploited.
	The FSA should identify the responsibilities it wants consumers to take on when interacting with the financial services markets and how its financial capability programme, alongside other regulatory action, will help to equip consumers for these responsibilities. It is also important that the FSA, in consultation with its stakeholders, begins in good time to develop its strategic priorities and approach to financial capability beyond 2011.	■ Although financial capability is different depending on the circumstances, the FSA may want to set out scenarios of the actions a capable consumer might take e.g. the savings rates of a consumer with certain demographic, socio-economic characteristics. ■ The next phase of the strategy could include how the FSA will use its regulatory powers, for example under Treating Customers Fairly, to encourage industry to take on greater responsibility for responding to consumer levels of financial capability. It could also use its knowledge of firm activity, for example in financial promotions, to point to examples of good practice in influencing consumers to make sensible financial plans and decisions. ■ The FSA may want to set out its views on the development of its strategy in conjunction with the government's long-term approach to financial capability. ■ The FSA could include details of how it will link its activity in with other financial capability initiatives including media campaigns. ■ The FSA could develop thinking on how it could link its work to improve the financial capability of segments of the population with behaviour change activity in other areas such as health improvements and sustainability.

Terms of Reference Area	NAO recommendation	Supporting suggestions and ideas for implementation
Financial Capability *continued*		■ There is a lot of activity which could contribute to improved levels of financial capability including media campaigns such as the Metro debt campaign, TV programmes such as How to pay off your mortgage in two years and websites such as uswitch and money supermarket. The FSA could further explore how it can develop closer links with these organisations and campaigns, for example building on the relationship developed with the BBC on the financial healthcheck to explore other areas for collaboration. ■ Many private sector firms employ creative marketing strategies for example sponsorship, using new web developments such as My Space or targeting 'key' customers who are likely to have large networks which they can influence. The FSA could recruit from, second to or consult with such firms to learn lessons for its own work. ■ The FSA could improve the linkages between its products – as it is by distributing the New Parents Money Box through the HR departments of workplace seminars. The workplace seminars could provide pointers to other projects and, for example, links between the young adults and new parents projects could be increased. ■ With the Government now taking the lead on Money Advice the FSA could expand its innovation fund. The fund appears to offer the potential to support the development of projects which can reach target audiences segmented by life stage, key decision points, motivations etc and provide ongoing impact for relatively little investment by the FSA. ■ The FSA should begin stakeholder consultation on the development of its strategic thinking on financial capability post 2011 as early as possible to ensure stakeholders feel they have adequate input and influence.

ENDNOTES

Executive Summary

1 The financial sector is the largest contributor to the UK balance of payments and contributed 8.5 per cent of UK GDP in 2005.

2 These activities include deposit taking (e.g. banks), insurance, mortgage lending, general insurance advice (e.g. motor, home), mortgage advice and investment business.

3 The Financial Services and Markets Act 2000, Part 1.

4 The FSA also regulates by reference to its own principles of good regulation.

5 It is common in financial services circles to refer to the 'twin peaks' of financial services regulation: market confidence and stability (known as prudential regulation) and consumer/investor protection (known as conduct of business regulation). These factors form a core part of the FSA's objectives, but are joined with a focus on financial crime and financial capability, so that in effect there are 'four peaks' of UK financial regulation.

6 This division is more than simply a difference between the wholesale and retail parts of markets. Rules are crucial in many elements of wholesale markets; principles are an important and growing factor in the regulation of retail financial services. For example, the FSA has developed an approach called Treating Customers Fairly for its regulation of retail financial services.

7 *Sustaining New York's and the US's Global Financial Services Leadership*, January 2007.

Introduction

8 Net exports of the financial sector totalled £19 billion in 2005.

9 The Chancellor announced the merger of investment services regulation and banking supervision into the Securities and Investments Board in 1997, which then changed its name to the Financial Services Authority.
In June 1998 responsibility for banking supervision was transferred to the FSA from the Bank of England.
In 2000, the FSA took over the role of UK Listing Authority from the London Stock Exchange. The Act transferred the responsibilities of several other organisations to the FSA: Building Societies Commission, Friendly Societies Commission, Investment Management Regulatory Organisation, Personal Investment Authority, Register of Friendly Societies and Securities and Futures Authority.
The FSA took on responsibility for mortgage regulation in 2004 and general insurance in 2005.

10 Under Section 19 of FSMA, any person who carries on a regulated activity in the UK must be authorised by the FSA.

11 For example, fitness and propriety issues/threshold conditions, market protection, systems and controls, Listing rule breaches, selling (mis-), pensions and endowments, retail mediation activities return, non-compliance with the Financial Ombudsman Service, Money Laundering Controls and financial fraud.

12 The National Audit Office's terms of reference refer to this as the Strategic Performance Framework, the FSA has subsequently renamed this as the Outcomes Performance Report, which is the term used throughout this report.

Part 1: Performance Management

13 For example, whether the firm is holding sufficient capital, the amount of client money held, if it holds professional indemnity insurance, and levels of staff training. The FSA will implement a new system in mid 2007, allowing up to 180 checks to be carried out.

14 Risk appetite refers to the level of harm or failure in financial services it is prepared to accept or tolerate – in this case the level of risk to its statutory objectives that the FSA is prepared to bear.

15 FSMA Schedule 1(10) (1) (b) requires the FSA to report on “the extent to which, in its opinion, the regulatory objectives have been met”.

16 HM Treasury, Cabinet Office, National Audit Office, Audit Commission & Office For National Statistics, *Choosing the Right Fabric: A Framework for Performance Information*, 2000.

17 Financial Services Practitioner Panel (2006), *Fourth survey of the FSA’s Regulatory Performance* (p.78) – for example, when asked about FSA supervisors, 55 per cent of respondents did not agree that supervisors have a good understanding of their firm’s business.

18 In the FSA staff survey (question 54): In the 2005 results, two in every five respondents did not agree that staff performance reviews in their department were held regularly and on time.

19 The three indicators were (1) percentage of firms on amber watchlist for more than one year; (2) rookie ratio (proportion of staff with less than two years employment at the FSA, driven higher by the inclusion of Mortgage and General Insurance regulation within the FSA’s scope in 2004-05); and (3) projects with performance measurement data collected and reported within three months of scheduled completion.

20 Financial Services and Markets Act 2000, Schedule 1(4)(3)(a).

21 *Annual Report 2002-03*, p.148–150 (Directors’ report) and p.155 (non-executive directors’ report).

22 FSA Annual Report 2005-06, p.58 (non-executive directors’ report): “During the year, NedCo kept under review whether the FSA is using its resources efficiently and economically. NedCo challenged information provided to it, sought further explanation where appropriate and encouraged enhancements to the reporting framework on a continuous improvement basis.”

Part 2: Working with other UK Regulators

23 The FSA and the OFT conducted a data matching exercise of their regulated populations that confirmed there were some 22,100 firms regulated in some capacity by both organisations. These are firms which conduct regulated activities under FSMA and also hold consumer credit licences from the OFT.

24 *Delivering better regulatory outcomes – an update: A joint FSA and OFT Action Plan*, November 2006.

25 The review of the retail distribution system is aimed at identifying and addressing the root causes of problems that continue to emerge in the retail investment market. The review’s priority areas include: sustainability of the distribution sector; impact of incentives; professionalism and reputation; consumer access to financial products and services; and regulatory barriers and enablers.

26 Under the depolarisation regime which came fully into effect in June 2005, advisers must provide two ‘key facts’ documents, entitled ‘about our services’ and ‘about the cost of our services’. These give consumers much clearer information earlier in the sales process about the type of advice and level of service being provided by the adviser. The post-implementation review will comprise several stages to assess how the market changes over time. As a first stage, the FSA has carried out a compliance review to assess how well firms are applying the rules.

27 The FSMA 2000 does require the FSA to have regard to the need to minimise the adverse effects on competition that may arise from their activities and the desirability of facilitating competition between the firms regulated by the FSA.

28 Under sections 302–304, the OFT has a similar duty to keep the provisions and practices of investment exchanges and clearing houses under review.

29 The OFT must make a report to the Competition Commission if it considers that regulating provisions or practices of the FSA result in a significant adverse effect on competition. The Competition Commission must then investigate the matter and if appropriate make a report to HM Treasury, which may make directions to the FSA to remedy the situation.

30 *Competition Review of the Financial Services and Markets Act 2000*, A report prepared for the OFT by Oxera. This review formed part of a broader two-year review of the FSMA, announced by HM Treasury in November 2003.

31 The seven markets identified were: the provision of current accounts to SMEs and individual consumers; trading exchanges; clearing and settlement infrastructure; credit rating agencies; pension fund consultants; investment banking, specifically initial public offerings and mergers and acquisitions; and custody services.

32 *Reducing Administrative Burdens: effective inspection and enforcement*, Philip Hampton, March 2005.

33 The application processes operated by the FSA and the OFT require the firms applying to provide certain types of information. Some of this information is required by both the FSA and the OFT and so firms have to submit duplicate information.

34 Only approximately 300 firms apply simultaneously to the FSA and OFT each year, and a further 600–700 firms that are already regulated by the FSA or OFT apply to become regulated by the other each year.

35 The industry user group comprises the Council of Mortgage Lenders, the Finance and Leasing Association, the Association of British Insurers, the British Bankers' Association, the FSA Smaller Businesses Practitioner Panel, the Consumer Credit Association UK, the British Cheque Cashers Association, the Consumer Credit Trade Association, and the Association of Payment and Clearing Systems.

36 In late March 2007 the OFT announced an in-depth study of retail bank pricing. The OFT expects the study to be completed by the end of 2007.

37 The FSMA Disclosure of Confidential Information Regulations 2001.

38 As at 26 February 2007, the FSA announced it had fined five firms over poor PPI selling practices, and had imposed public censure on two firms. Two other cases had also been concluded where problems relating to PPI also featured. Other PPI enforcement investigations were also underway at that time.

39 The Banking Codes Review is an independently led triennial review into the self-regulatory codes of practice governing British personal and small business banking. (See paragraph 2.32).

40 Between April to November 2005 however the FSA was not able to pass confidential information to TPR because the relevant changes to statutory instruments had not been made. HMT were responsible for ensuring this legal obstacle was removed.

41 Contract-based arrangements consist of individual personal pension policies owned by the individual members. They are schemes provided by insurance companies, friendly societies etc.

42 TPR's statutory responsibilities for work-based pensions extend to contract-based pensions where there is a direct payment arrangement from the employer to the provider.

43 Advice would be subject to the FSA's existing rules if it involved opting out of an occupational pension scheme into a personal pension for example.

44 TPR have recently issued a consultation on inducements. TPR *Inducement Offers*, January 2007.

45 The FRRP's functions were extended under both Companies (Audit, Investigations, and Community Enterprise) Act 2004, and the Supervision of Accounts and Reports (Prescribed Body) Order 2005.

46 FSMA (Disclosure of Confidential Information) (Amendment) Regulations 2006 (SI 3413).

47 Similar single invoicing arrangements exist between the FSA, the FOS and the FSCS.

48 The FSA first set out its 11 high level principles that set overarching requirements for all financial services firms in 2001.

49 In addition to the bodies listed below, the FSA also has relations with other bodies such as the Takeover Panel, Her Majesty's Revenue & Customs etc.

50 The FOS is responsible for the operation of the scheme for resolving disputes between financial services firms and consumers. It appoints the ombudsmen and the Chief Ombudsman, and makes the rules of procedure for reference of complaints to the scheme and for their investigation, consideration and determination. In addition, it make rules relating to the award of costs, and the levying of case fees, recommend an annual budget for approval by the FSA, and report to the FSA on the discharge of their functions.

51 The FSA is responsible for appointing and removing of the directors of the FOS, and ensuring that the FOS is at all times capable of exercising the functions conferred on it under FSMA. The FSA approves the FOS's budget and makes and approves the rules of the FOS's complaints' jurisdiction.

52 These are where complaints that are handled by the FOS may have wider regulatory implications, including for firms and consumers. In March 2005, the FSA and the FOS published updated arrangements for the referral of issues that may involve wider implications. The new arrangements clarified the different roles and responsibilities of the two bodies when a wider implications referral is received, and enhanced the way the two organisations cooperate on these issues.

53 The FSCS responsibilities include the effective operation of a single compensation scheme and overseeing the orderly wind-down of work (to which the Rules of the old schemes apply); making and implementing procedures to enable the FSCS to operate its functions; making levies for management expenses, compensation costs and establishment costs as are required under the Rules to enable it to carry out its role; and reporting to the FSA on the discharge of their functions.

54 The FSA is responsible for ensuring that the FSCS is capable of exercising its functions by: ensuring that any rules made by the FSA can be administered effectively; ensuring that the rules do not unreasonably constrain the FSCS's ability to raise sufficient funds to meet the costs incurred in discharging its responsibilities under the Act and under the rules; notifying the FSCS of any circumstances which may impact on its ability to meet the objective of administering the rules in a fair and cost-effective manner; and appointing appropriate persons to the FSCS's Board.

Part 3: Influencing and representation internationally

55 *Sustaining New York's and the U.S.'s Global Financial Services Leadership*, Report by McKinsey & Company for New York Mayor Michael R. Bloomberg and Senator Charles E. Schumer, January 2007. "Many commentators have …..questioned whether several new EU directives sufficiently enhance investor protection and market efficiency to warrant the costs entailed." page 91.

56 *The overall impact of MIFID*, FSA November 2006. This commentary is in addition to the detailed cost-benefit analyses that the FSA is obliged to undertake on individual proposed rule changes for MIFID.

57 The Committee was set up in July 2000 and reported in February 2001. Its terms of reference included: assessing the current conditions for implementation of the regulation of the securities markets in the EU; identifying a critical path to achieving the Financial Services Action Plan; assessing how the mechanism for regulating securities markets in the EU can best respond to developments; and proposing scenarios for adapting current practices in order to ensure greater convergence and cooperation in day-to-day implementation.

58 A qualified majority refers to the number of votes required for a decision to be adopted, with votes weighted according to a country's population.

59 John Tiner speech 11 October 2006 to BBA Annual Conference, London refers to "the need to reach consensus can still compromise/undermine the quality of the final outcome".

60 John Tiner speech 11 October 2006 to BBA Annual Conference, London.

61 'The European Equities Post-Trading Industry: Assessing the Impact of Market and Regulatory Changes', The City of London Corporation, February 2007.

62 The FSA devotes some five person years to this role.

63 Committee of European Securities Regulators.

64 Committee of European Insurance and Occupational Pensions Supervisors.

65 Committee of European Banking Supervisors.

66 Whilst the majority of staff time on EU and International issues is provided by the FSA's Wholesale and Prudential Policy Division and Retail Policy Division, the FSA estimates that at least an additional 17 person years of resources are spent on EU and international issues across a range of other divisions in the FSA, including the central unit on International Strategy and Policy Co-ordination.

67 In particular to achieve a set of managed regulatory relationships for internationally active financial institutions.

68 Including promoting a more harmonised regulatory culture by developing pan-EU common training for regulatory staff, and adoption of impact assessment guidelines.

69 *White Paper on Financial Services 2005-2010*, European Commission, December 2005.

70 For example, the White Paper commits to setting up a permanent group of consumer representatives from across Europe – similar to the Financial Services Consumer Panel.

71 John Tiner speech to APCIMS, 13 October 2006.

72 *Sustaining New York's and the U.S.'s Global Financial Services Leadership,* Report by McKinsey & Company for New York Mayor Michael R. Bloomberg and Senator Charles E. Schumer, January 2007.

73 *The Competitive Position of London as a Global Financial Centre*, The City of London Corporation, November 2005. Updated by the Corporation's Report *The Global Financial Centres Index*, March 2007.

74 *The Financial Services Practitioner Panel, Annual Report 2005-06*.

75 The Financial Services Consumer Panel praised the FSA for having been a strong voice for the UK consumer in the discussions on European proposals, and for ensuring that as much as possible, the needs and position of UK consumers are taken into account. *Financial Services Consumer Panel Annual Report 2005-06*.

76 John Tiner speech 13 October 2006 to APCIMS Annual Conference, Barcelona.

77 Sir Callum McCarthy, Mansion House speech, 20 September 2005.

78 DG Market website: FAQs on EU financial services policy for the next five years.

79 *Davidson Review Implementation of EU legislation*, Final Report November 2006.

80 *The Governance Structure for Financial Regulation and Supervision in Europe*, Dr Rosa M. Lastra, Columbia Journal of European Law, 2003.

81 John Tiner speech to the French Chamber of Commerce, 25 Nov 2005.

82 *European Regulation and Supervision of Financial Services*; A paper for the City EU Advisory Group, April 2005. The report was produced by a working group in the City of London drawn from a broad range of international financial services interests.

83 The European Central Bank favours such an approach for banking services.

84 The European Financial Services Round Table has called for a lead supervisor for cross-border financial institutions: *Towards a lead supervisor for cross border financial institutions in the European Union*, June 2004. The purpose of the Round Table is to provide a strong industry voice on European policy issues relating to financial services, in particular the completion of the single market in financial services. The members of the Round Table include Chairmen and Chief Executives of leading European banks and insurance companies.

85 Ibid, Dr Rosa M. Lastra, Columbia Journal of European Law, 2003.

86 Institute of International Finance, *Proposal for a Strategic Dialogue on Effective Regulation*, December 2006.

87 *Sustaining New York's and the U.S.'s Global Financial Services Leadership,* Report by McKinsey & Company for New York Mayor Michael R. Bloomberg and Senator Charles E. Schumer, January 2007.

88 The US Committee on Capital Markets Regulation has called for the US to move to principles-based regulation. In addition there has been a high-profile call on the same theme by U.S. Treasury Secretary Henry M. Paulson: *Competitiveness of the US Capital Markets*, Economic Club of New York, November 20, 2006.

89 *The Competitive Position of London as a Global Financial Centre*, The City of London Corporation, November 2005.

Part 4: Financial Crime

90 Section 6 (1), FSMA.

91 Appendix 4a provides an outline of the Money Laundering Offence.

92 The FSA may be able to collaborate with HM Revenue & Customs, which develops and publishes a wide range of tax evasion estimates such as VAT fraud and excise diversion fraud or smuggling.

93 A joint HM Treasury, Home Office, Serious Organised Crime Agency and Foreign and Commonwealth Office Publication.

94 PriceWaterhouseCoopers (2005), *Global economic crime survey 2005: United Kingdom*. This focuses on crime volume/firms affected, crime type, cost to firms, means of detection, type of perpetrator, reporting/investigation, regularity of board level engagement (http://www.pwc.com/gx/eng/cfr/gecs/PwC_GECS05_United_Kingdom.pdf).

95 Levi et al, *Economic impact of Fraud in the UK*, February 2007.

96 Monteiro, Zaman, Leitterstorf for the FSA, *Updated Measurement of Market Cleanliness*, March 2007.

97 The measurement did show a decrease between 2004 and 2005. For FTSE350 trading the measure of informed trading was significantly lower than the period before FSMA was introduced.

98 For example, the FSA has placed the risk of organised criminal groups corrupting firms' employees on the dashboard.

99 As outlined in the new Joint Money Laundering Steering Group industry guidance.

100 This contrasts with the approach adopted by HM Revenue & Customs to money laundering supervision of Money Service Businesses and High Value Dealers. It carries out a specialised risk assessment on the population (4,500 traders & 35,000 branches) based on business type, compliance, intelligence and levels of money transmitted. This then determines its visit programme – in the past five years, every Money Service Business has been visited at least once.

101 These relate to areas such as capital held, client money held, levels of staff training.

102 FSA's Small Firms Division recently examined levels of awareness of new anti-Money Laundering provisions at 100 small investment firms. It is also working with trade associations of higher risk sectors to distribute training material.

103 Our calculation of the overall percentage of resources spent by the FSA on financial crime is similar whether worked out by staff time or by cost. However, the percentage of resources allocated to the various activities within financial crime such as intelligence or enforcement

vary depending on whether it is calculated by staff time or cost. Given the lack of cost information this is the best estimation which can be achieved.

104 The NAO's calculation of overall resource allocation is sensitive to the estimate we used of the proportion of time spent by the FSA's supervisors on financial crime (in this exercise, we used the FSA's estimate of 10 per cent). An increased proportion of time would have a significant effect on the calculation of total costs dedicated to financial crime: £32 million (using 15 per cent of time) and £38 million (using 20 per cent of time).

105 The FSA publicly announced this change at its Financial Crime conference on 22 January 2007.

106 Financial Services and Markets Act 2000, s.354(b) (http://www.opsi.gov.uk/acts/acts2000/00008-ah.htm#354).

107 Attorney General (2006), Fraud Review, 24 July 2006 (http://www.lslo.gov.uk/pdf/FraudReview.pdf).

108 Its annual Financial Risk Outlook highlights these issues.

109 There are currently 31 FATF member countries.

110 The mutual evaluation of the UK regime was carried out by FATF in December 2006, with the results due to be published in summer 2007. The 40 recommendations and 9 special recommendations can be viewed on the FATF site (http://www.fatf-gafi.org/document/28/0,2340,en_32250379_32236930_33658140_1_1_1_1,00.html#40recs).

111 Financial Services and Markets Act 2000, s.169 (http://www.opsi.gov.uk/acts/acts2000/00008--n.htm#169).

112 http://www.sec.gov/about/secpar/secpar2006.pdf#sec2.

113 FSA Handbook PRIN 2 (http://fsahandbook.info/FSA/html/handbook/PRIN/2/1).

114 Money Laundering Regulations 2003, Part 2, 3(1)(2a), "A person who contravenes this regulation is guilty of an offence and liable on conviction on indictment, to imprisonment for a term not exceeding 2 years, to a fine or both".

115 Market Watch newsletter 18 Dec 2006, (http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter18.pdf).

116 http://www.fsa.gov.uk/pubs/other/money_laundering/letter_310806.pdf (31 August 2006).

117 John Tiner, Speech at the FSA's Annual Financial Crime Conference, January 2007.

118 Section 118 and section 91, FSMA.

119 The FSA can prosecute the following criminal offences: carrying on a regulated activity without authorisation; breaching restrictions on financial promotions; advertising without approval; failing to cooperate or supply information to FSA investigations; making misleading statements and market manipulation; insider dealing; and breaching money laundering regulations.

120 The FSA first announced plans to tender for a platform to replace its existing system in June 2005. It signed a letter of intent in December 2006 with IT consultancy, Detica, to deliver the new system (to be in place by the end of 2007) over a seven year contract valued at £17 million. The new system will analyse market activity in real-time to detect potentially illegal patterns of trading (http://www.detica.com/indexed/NewsItem_FSA-LOI.htm).

121 FSA (2006), *Implementing MiFID for Firms and Markets*, Consultation 06/14, Annex 2, para 10.13, p.57.

122 The others are contract certainty, credit derivatives, payment protection insurance and Treating Customers Fairly.

123 Market protection includes insider dealing, market manipulation, market abuse and code of market conduct.

124 US Securities and Exchange Commission annual reports. In addition, the two main US self-regulatory organisations also undertake over 1,000 cases between them (New York Stock Exchange and National Association of Securities Dealers).

125 Like the SEC, the FSA measures and monitors referral of cases, proportion of enforcement cases filed within a time limit and then successfully resolved, penalties imposed, requests by foreign regulators for enforcement assistance, and the distribution of cases across core enforcement areas (e.g. insider dealing).

126 For example, some preliminary research from Harvard Law School investigates the linkages between the staffing and budget levels of securities regulators around the world and the effectiveness of their enforcement efforts by developing an index to compare resourcing levels across 28 countries, incorporating budget, staff numbers, GDP and population. Australia and Hong Kong were highest, UK mid-level, and Germany and Austria lowest. Jackson H & Roe M (2006), *Public Enforcement of Securities Laws: Preliminary Evidence*, Harvard Law School, October 2006.

Part 5: Financial Capability

127 FSA, *Building Financial Capability in the UK*, March 2005.

128 Government Communications Network Engage (http://engage.comms.gov.uk/). Other principles are: express policy in a way that makes sense to target audience; feeding the views of the public into all aspects of policy development and service delivery; and being open and accountable in all communication and marketing activities.

129 General Accounting Office, *Further Progress Needed to Ensure an Effective National Strategy*, GAO-07-100 (www.gao.gov). The New Zealand Retirement Commission also carries out schools and workplace financial education.

130 The Resolution Foundation recently published research modelling the potential impact on the financial services industry of a national generic advice service. (Resolution Foundation, *The Advice Gain: The impact of generic financial advice on the financial services industry*, March 2007).

131 FSA, *Delivering Change*, March 2006.

132 John Tiner, *Financial Capability: Making a difference*, FSA/HMT Financial Capability Conference, 18th October 2006.

133 For example, Government Communications Network Engage programme (www.engage.comms.gov.uk) and the National Centre for Social Marketing (www.nsms.org.uk).

134 Organisation for Economic Cooperation and Development, *Improving Financial Literacy*, 2005.

135 Bernheim and Garrett, *The effects of financial education in the workplace*, August 2003.

136 Bernheim & Garrett, *Education and Saving: the long-term effects of high school financial curriculum mandates*, June 2001.

137 Institute of Public Policy Research, *Rethinking financial capability*, 2006.

138 *Losing interest: How much can consumers save by shopping around for financial products?* FSA occasional paper series 19, October 2002.

139 *A National Dividend: the economic impact of financial advice*, Resolution Foundation, September 2006.

140 Financial Services Authority, *Towards a National Strategy for Financial Capability*, 2003; *Building Financial Capability in the UK*, 2004; *Results of the Baseline Survey*, 2006 and *Delivering Change*, 2006.

141 Originally schools, work, young adults, families, retirement, borrowing and advice.

142 COI Strategic Consultancy for the Office of Fair Trading, *Consumer Education: establishing an evidence base*, April 2006.

143 Generic advice is unregulated advice which takes account of the specific financial circumstances of an individual but does not result in a product recommendation. The Resolution Foundation estimates a national generic advice service could cost up to £110 million; the FSA would not have been able to provide this level of funding. (Resolution Foundation, *Closing the advice gap: Providing financial advice for people on low incomes*, May 2006).

144 *Financial Capability: the Government's long-term approach* mapped out at least 60 initiatives by the financial services industry and third sector. OFT's *Consumer Education: establishing an evidence base* (April, 2006) found that the finance sector accounted for 40 per cent of consumer education initiatives examined.

145 The Enterprise Act 2002 gives the OFT powers to use consumer education to support its work in making markets work well for consumers.

146 HM Treasury, *Financial Capability: the Government's long term approach*, January 2007.

147 Better Regulation Commission, *Risk, Responsibility and Regulation*, October 2006.

148 FSA, *Treating Customers Fairly – towards fairer outcomes for consumers*, July 2006.

Terms of reference

149 The FSA has renamed this as the Outcomes Performance Report, which is the term used throughout the report.

Appendix 2: Working with other regulators

150 Both organisations have powers over unfair contract terms under the *Unfair Terms in Consumer Contracts Regulations 1999*.

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