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.

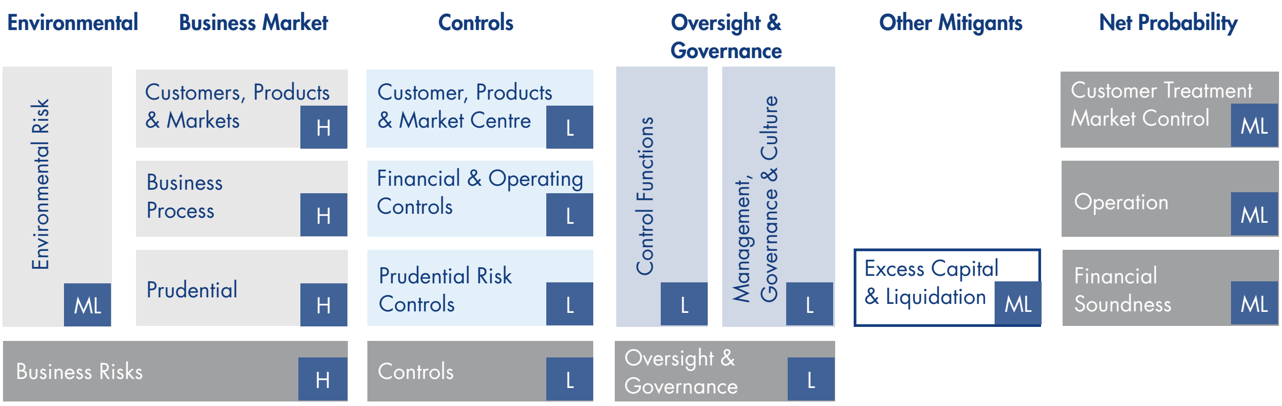
1.4 The Advanced, Risk-Responsive Operating FrameWork (known as ARROW) is the FSA's system to assess risk and decide where to focus supervisory activity. It aggregates a series of judgements about the risk levels for each firm for the following elements (**Figure 4**):

- 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.

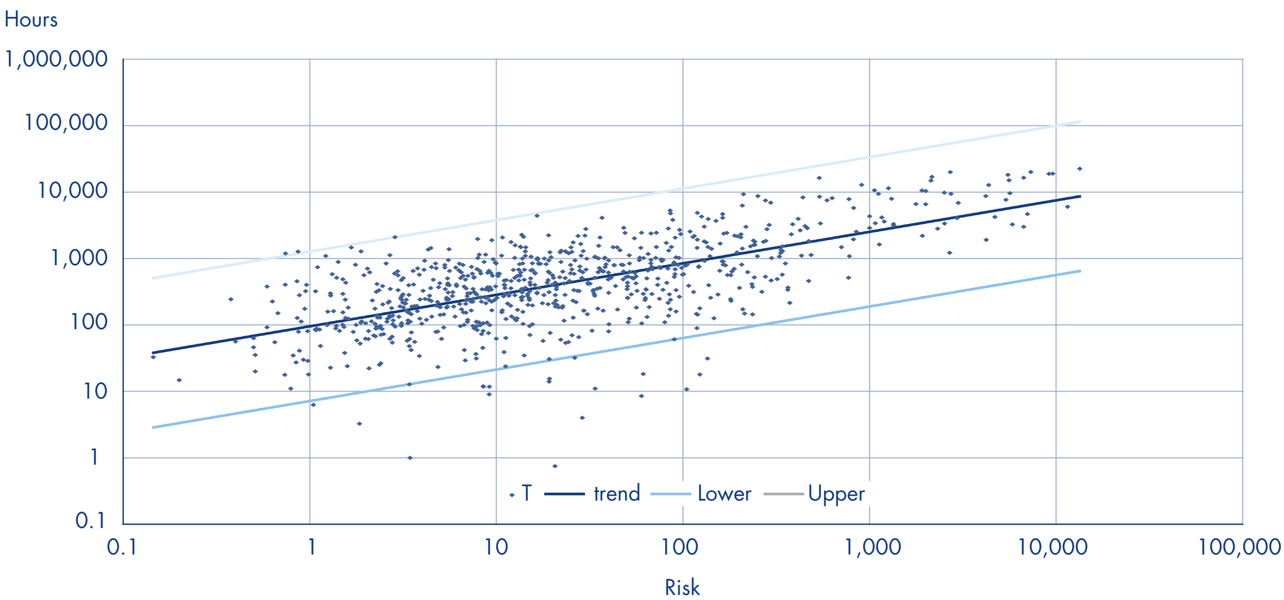
Measuring performance

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.