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.