

A review supported by the
Better Regulation Executive
and National Audit Office

Effective inspection and enforcement:

implementing the Hampton vision in the Financial Services Authority

Foreword

Philip Hampton's report: *Reducing administrative burdens: effective inspection and enforcement*, published in 2005, is one of the cornerstones of the Government's better regulation agenda. The principles of effective inspection and enforcement set out in the report, putting risk assessment at the heart of regulatory activity, are designed to encourage a modern regulatory system which properly balances protection and prosperity. Since 2005, the Government has established an expectation that regulators will embed these principles in their approach to regulation.

In November 2006, the Chancellor of the Exchequer invited the National Audit Office and the Better Regulation Executive to develop a process of external review to assess how much progress regulators had made in implementing the principles of Hampton.

The first five regulators assessed under the process of 'Hampton Implementation Reviews' are amongst the most significant in this country. The Environment Agency, Financial Services Authority, Food Standards Agency, Health and Safety Executive and Office of Fair Trading regulate millions of businesses, covering some key areas of economic activity, whilst protecting the interests of us all. How they carry out their regulatory activities matters.

Full implementation of Philip Hampton's recommendations is a journey that could take several years. This review is a 'snapshot' in time of the progress of each regulator towards his vision.

Each of the reviews found examples of innovation and initiative by regulators who continue to move the regulatory agenda forward, as well as areas for further improvement.

The assessments were carried out by teams of reviewers with wide-ranging experience and expertise in the field of regulation. Talking to a wide range of stakeholders, to staff at all levels within the regulator's organisation, through visits to business sites and analysis of data and papers, the review teams, supported by staff from the Better Regulation Executive and the National Audit Office, have reached the findings and conclusions set out in this report. The final reports reflect the judgement of these review teams on the basis of the evidence put before them.

We would like to thank all of those who contributed to making these reviews a success. In particular, we are grateful to the regulators and their staff for providing support and making evidence available to the review teams, and to all the organisations that generously gave their time to offer evidence to the reviews.

Finally, we are extremely grateful to all our reviewers, and their employers, for their involvement, enthusiasm and commitment to this project. We hope that, like us, they found it valuable and rewarding.



Jitinder Kohli
Chief Executive
Better Regulation Executive



Ed Humpherson
Assistant Auditor General
National Audit Office

Contents

	Page no
Summary and conclusions	5
Issues for follow up	7
Introduction	9
The Hampton vision	11
Design of regulations	14
Advice and guidance	20
Data requests	25
Inspections	28
Sanctions	34
Focus on outcomes	40
Appendix 1	
Review team membership	42
Appendix 2	
Conclusions of the Hampton and Macrory reviews	43
Appendix 3	
Review scope and methodology	45

Summary and conclusions

This review is part of a series of reviews of regulatory bodies undertaken at the invitation of HM Treasury and focusing on the assessment of regulatory performance against the Hampton principles and Macrory characteristics of effective inspection and enforcement. It was carried out by a team drawn from the Better Regulation Executive, the National Audit Office (NAO), the Food Standards Agency and the National Consumer Council, supported by staff from the Better Regulation Executive and NAO (see Appendix 1 for review team membership).

The Hampton report¹, published in 2005, is one of the cornerstones of the Government's better regulation agenda and regulators have been working since then to embed his principles in their approach to regulation. This review process is designed to identify where a regulator is on the road to full implementation and the issues each needs to address to become Hampton-compliant.

Whilst this review took place during the time that the Financial Services Authority (FSA), along with the Bank of England and the Treasury, were dealing with the liquidity problems of Northern Rock plc, its scope did not include the specific analysis of Northern Rock, nor the adequacy or otherwise of the FSA's specific risk-assessment for that organisation.

As part of the review, we did meet with the FSA Director of Internal Audit for a briefing on the internal review of Northern Rock that is currently underway within the FSA². The conclusions of this review will be published in March 2008.

What we found

The review team concluded that to a high degree, the FSA regulates in accordance with the Hampton principles and Macrory characteristics. The review team rated it highly on focusing on outcomes, consulting with stakeholders and having an embedded culture of "better regulation". Areas to develop include simplifying data requests from small firms, ensuring continuity of supervisory staff and ensuring that an appropriate balance is achieved in the use of its different sanctioning options.

- **The FSA has internalised a strong culture of 'better regulation'** – the FSA as an organisation appears to have internalised the key elements of 'better regulation', and has made strong progress on implementing the principles.
- **The FSA is a leader in driving the better regulation agenda in Europe** – it is using its influence to try and increase the importance attached to cost benefit analysis in the development of European Financial Services policy.
- **The FSA is always looking to enhance transparency and accountability** – this reflects the view of stakeholders although we believe that there is more that the FSA could do in providing information to the consumer that could influence their behaviour, such as mystery shopping data.

¹ Reducing administrative burdens: effective inspection and enforcement, Philip Hampton, HM Treasury, March 2005

² www.fsa.gov.uk/pubs/other/memo_TSC.pdf

- **The FSA recognises the need to minimise the burden of regulation on business** – and undertakes market failure and cost benefit analyses as a matter of course.
- **The FSA has a systematic risk assessment approach** – that is rigorously used throughout the organisation to prioritise activity and is commonly understood by staff. However, no risk assessment system is perfect as demonstrated by the Northern Rock crisis, the subject of an internal FSA review.
- **The FSA consults comprehensively with external stakeholders** – and this consultation actively makes a difference to FSA policy proposals.
- **The FSA has rigorous internal challenge processes in place** – and these help ensure consistency across a number of areas. However, the FSA should ensure that these processes do not become a barrier to efficient enforcement.

Issues for follow-up

The following table sets out the key issues that the review team believes the FSA needs to address to meet the Hampton criteria more

fully, measured against some of the symptoms³ we were looking for to provide evidence of Hampton compliance.

Issue to be addressed	Hampton symptom
<p>Advice and guidance to smaller firms</p> <p>The review team recognises that the FSA has increased its efforts in recent years to target its advice and guidance to smaller firms more effectively. However, the review team consider that the FSA should build on these efforts to further help small firms to meet their regulatory requirements. The review team welcomes the FSA's Small Firms Strategy which should be a driver for this process.</p>	<ul style="list-style-type: none"> • Advice services address the full range of business requirements; where appropriate, advice is tailored to the needs of SMEs, large business, particular sectors etc
<p>Data requests to small businesses</p> <p>Some aspects of the FSA's current data collection requirements for small firms appear excessive, especially given the FSA's overall risk-based approach to regulation. Whilst the review team recognise that data from the Retail Mediation Activity Return (RMAR) can provide useful information to inform the FSA's risk-based approach, the review team asks the FSA to explore a more targeted and proportionate system of collecting data from smaller firms (for example through a slimmed-down data request; or by moving from requesting 6-monthly returns from all small firms to sampling from within the population of small firms). Such approaches could give the FSA the data it requires to monitor the market whilst reducing administrative burdens for a large proportion of the firms that it regulates.</p>	<ul style="list-style-type: none"> • Forms/data requests are clear and targeted and risk-assessment is used to determine the level of information required
<p>Continuity of supervisory staff</p> <p>The FSA experiences significant staff turnover in key supervisory grades, which can negatively affect the consistency and quality of the supervisory relationship. Whilst industry was supportive of the FSA's move to 'More Principles-Based Regulation', concerns were expressed to the review team by stakeholders that high-levels of turnover amongst supervisory staff was militating against FSA staff having the requisite skills to deliver this outcome.</p>	<ul style="list-style-type: none"> • Training and guidance for inspectors encourages a proportionate approach to inspection

³ From Hampton Implementation Reviews: Guidance for Review Teams. National Audit Office and Better Regulation Executive, May 2007

Issue to be addressed	Hampton symptom
<p>Sanctioning options</p> <p>The FSA needs to ensure that an appropriate balance is achieved in the use of different sanctioning options.</p> <p>Whilst the review team are not calling for the FSA to develop an enforcement-driven strategy, the review team considers that the current sanctioning culture may have lowered the profile of enforcement options within the FSA's overall sanctioning strategy.</p> <p>The FSA should place greater emphasis on the principle of 'credible deterrence' as a means of securing compliance.</p>	<ul style="list-style-type: none"> • Enforcement actions are proportionate to the seriousness or the persistence of, and potential commercial gain from, the compliance breach

Introduction

- 1 This review of the Financial Services Authority (FSA) aims to provide a structured check on performance against the principles and characteristics set out in the Hampton⁴ and Macrory⁵ reports (see Appendix 2). The team reviewed the FSA against a performance framework⁶ developed by the Better Regulation Executive and the NAO which provides a guide for reviewers on the kind of evidence to look for and questions to consider. However, the process is not the same in scope or depth as a full value for money audit of economy, efficiency and effectiveness and the review team's conclusions are based on a combination of evidence and judgement. In addition, the review team considered the findings of the recent NAO section 12 report on the FSA⁷. A brief description of the scope of the review and methods employed is at Appendix 3.
- 2 The FSA is the principal statutory regulator of financial services in the UK. It authorises and regulates banks, insurance, mortgage lending, general insurance advice (e.g. motor, home), mortgage advice, financial advice (e.g. by independent financial advisers), investment business, credit unions, and registered investment exchanges. It is also the UK Listing Authority (UKLA) for quoted share issues.
- 3 Financial services and markets are regulated under the Financial Services and Markets Act 2000 (FSMA). FSMA's principal purpose is to grant powers to the FSA to set principles, make rules, and provide guidance to regulate financial services. HM Treasury sets the scope of financial services legislation – it is responsible for FSMA and for making secondary legislation to amend FSMA and has lead responsibility for negotiating financial services legislation in the European Union. The FSA Handbook sets out these principles and rules, with which firms must comply, and provides official guidance.
- 4 The FSA, as an organisation, was one of the world's first 'unified' financial regulators: between 1997 and 2005 it took over the role of some 11 other regulators. The FSA has a budget of around £320 million and employs some 2,700 staff. It regulates nearly 29,000 firms in the financial sector and is funded entirely by fees paid by regulated firms. The FSA's regulatory framework (FSMA) gives the FSA four main statutory objectives:
 - Maintaining 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
- 5 The task of the FSA has been summarised by the NAO as "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

⁴ Reducing administrative burdens: effective inspection and enforcement, Philip Hampton, HM Treasury, March 2005

⁵ Regulatory Justice: making sanctions effective, Final report, Professor Richard B Macrory, November 2006

⁶ Hampton Implementation Reviews: Guidance for Review Teams, National Audit Office and Better Regulation Executive, May 2007

⁷ The Financial Services Authority: a review under section 12 of the Financial Services and Markets Act 2000, National Audit Office, April 2007

⁸ The Financial Services Authority: a review under section 12 of the Financial Services and Markets Act 2000, National Audit Office, April 2007, pg 9

participants and consumers”.⁸ In addition, the statutory objectives are supported by a set of principles of good regulation which the FSA must have regard to when discharging its functions. These include principles of good regulation such as: the burdens imposed by regulation should be proportionate to the benefits and resources should be used in an efficient and economic way.

- 6** The sections that follow set out the review team’s findings against the different elements of the performance framework: the Hampton vision; design of regulations; advice and guidance; data requests; inspections; sanctions and focus on outcomes.

The Hampton vision

7 Both the Hampton and Macrory reports are concerned with effective regulation – achieving regulatory outcomes in a way that minimises the burdens imposed on business. Key to this is the notion that regulators should be risk-based and proportionate in their decision-making, transparent and accountable for their actions and should recognise their role in encouraging economic progress.

Risk-based

8 The FSA has well-developed systems for identifying risk and has operationalised a common understanding of risk within and throughout the organisation⁹. The FSA uses three main tools for reporting risk: the risk dashboard, Firms WatchList and the Interim Risk Manager (which records the outcomes and risks from their Advanced, Risk-Responsive Operating FrameWork (ARROW) assessments). To a certain extent, this is a process that is still developing.

9 There is a danger that the broad nature of the FSA's four statutory objectives, and the nature of what it calls its 'vertical supervision' can encourage its supervisory staff to interest themselves in issues that go beyond the scope of regulatory oversight into the 'shadow management' of a firm. During the review, the team came across examples where the line between regulatory issues, and issues that should be left for firms' management appeared to be blurred.

10 Overall, however, the review team considers that the FSA is aware of this danger and has robust internal challenge processes in

place to focus their activity on regulatory issues that pose a clear threat to their statutory objectives. We would encourage FSA to maintain their strong internal challenge processes, particularly in light of its move towards 'more principles-based regulation' (MPBR).¹⁰

11 Moving towards MPBR will require investment from the FSA to develop its workforce. Implementing such a change depends to a large extent on the quality of regulatory staff. One of the challenges we see for the FSA in the future is in recruiting and keeping good quality staff in an industry where there is a high degree of 'transferability' of regulatory staff to industry. The FSA recognises this as an issue and is putting in place strategies to manage this risk. Recruiting and retaining good quality staff is essential if the FSA is to ensure that it moves away from focusing on processes towards a flexible, more outcome-focused approach.

12 The FSA's risk management systems appear to be systematic, and consideration of risk drives the level of regulatory focus in the FSA. Nevertheless, no risk-assessment system is foolproof as the recent Northern Rock crisis highlights. Although the review team did not examine the Northern Rock issues during the course of the review, we were assured that FSA is conducting an internal review into the lessons that can be learned and will assess whether the failure to predict and prevent the crisis was due to a systematic problem with its risk assessment system. The conclusions of this review will be publicly available in March 2008.

⁹ For more detail of the FSA's risk-assessment process, see the 'Inspections' section

¹⁰ For more details of the FSA's move to 'more principles-based regulation', see the 'Advice and Guidance' section

We found:

- **Systematic systems for identifying risk and a shared common understanding of risk throughout the organisation;**
- **Robust internal challenge functions that mitigate against the risk of supervisory ‘mission creep’¹¹**

Transparency and accountability

Transparency

- 13** We recognise that there are limits to the extent to which the FSA can be wholly transparent, given the need for it to balance its statutory objectives and the specific limitations of the Financial Services and Markets Act 2000¹². In general, the FSA seeks to be transparent within this framework.
- 14** Nevertheless, we believe that there is scope for the FSA to develop greater transparency, specifically in providing more information to the consumer about the market – for example, the findings of its thematic investigative work such as mystery shopping findings – that will drive improved behaviour amongst firms and individuals operating in the market. We are pleased to note that the FSA is contemplating making positive moves in this direction, as a recent speech by Clive Briault, Managing Director of Retail Markets at the FSA, demonstrates;

“In addition to firms being open with their customers, another increasing demand both by and on behalf of consumers is for

greater transparency by public bodies about their judgements and decisions. And one aspect of this is a call for us as a regulator to reveal more about our view of the firms we regulate.”

“Because we see both the benefits of transparency and some risks around full transparency, we plan to publish a Discussion Paper early next year in which we will step back to consider the purpose and possible effects of greater transparency. We will look at the impact of transparency on the behaviour of both consumers and firms, and provide a basis for discussion on this important subject with all of our stakeholders.”¹³

Accountability

- 15** The FSA publishes a great deal of outline performance information and measures an array of performance indicators and metrics. Despite this, very few people outside of the organisation seemed aware of this information, or what was done with it. Within the organisation itself, we also found evidence that staff were unaware of the range of data that was collected corporately. It is perplexing that, whilst the FSA is improving, in terms of becoming a more effective regulator, it currently has no ‘consolidated story’ of success to tell the outside world and to tell its own staff. The FSA produce a number of lengthy documents (such as their Annual Report, Business Plan and Financial Risk Outlook), but there is nothing that summarises and brings together the FSA ‘story’ in a concise, coherent and reader-friendly way.

¹¹ By which we mean getting routinely involved in issues around a firm’s organisational or business strategy

¹² For example, Section 348 of FSMA prohibits FSA from disclosing any information about a firm/individual which they have obtained under the powers of the Act and which is not already in the public domain. They can however disclose information if consent is given, or if it is disclosed in the form of a summary or collection of information which does not reveal the identity of individual firms

¹³ Speech by Clive Briault, Managing Director, Retail Markets. FSA Treating Customers Fairly Conference 6 November 2007 http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/1106_cb.shtml

- 16 Drawing on a review of the information the FSA publishes about its activities, the views of stakeholder bodies we spoke to and interviews with FSA staff, **we concluded that, in the main, the FSA is always looking for ways to enhance transparency and accountability.**

Encouraging economic progress

- 17 The Hampton Report stated that “regulators should recognise that a key element of their activity will be to allow, or even encourage, economic progress and only to intervene when there is a clear case for protection”¹⁴. This requires regulations and their enforcement to be proportionate to the potential for harm and that regulators should be aware of their influence on economic progress. The design of regulations and their enforcement is covered in later sections.
- 18 Within the FSA, there is a clear articulation of how risks to the FSA’s main objectives themselves can undermine economic progress. For example, if market confidence declines, then the cost of capital for UK firms would rise. There is a clear link between market confidence and economic progress.
- 19 The FSA recognises its role as a regulator in encouraging economic progress, and balances this with its other statutory objectives. It is the only regulator under review to have an obligation under the ‘principles of good regulation’ of FSMA 2000 to maintain the competitive position of the UK. Additionally, FSA staff were able

to clearly articulate how their work contributes to this FSMA principle. The review team was impressed that the FSA appears to have internalised the intention of FSMA. **Overall, we found that the FSA fully recognises its role as a regulator in encouraging economic progress and has effectively instilled this message in its staff.**

¹⁴ From Hampton principles of inspection and enforcement, Box E2, pg 7

Design of regulations

Hampton principles

“All regulations should be written so that they are easily understood, easily implemented, and easily enforced, and all parties should be consulted when they are being drafted.”

“When new policies are being developed, explicit consideration should be given to how they can be enforced using existing systems and data to minimise the administrative burden imposed.”

Key findings

- **The FSA influences and intervenes effectively in Europe and internationally**
- **The FSA consults comprehensively with business and consumer groups**
- **The FSA undertakes market failure analyses and cost benefit analyses for every new piece of policy, although the clarity and accessibility of these could be improved**
- **The FSA has good challenge processes in place**
- **The FSA recognises the importance of undertaking post-implementation work and seeks to do so where resources allow**

Background

European Dimension

20 The financial services sector has experienced significant regulatory reform at EU level over the last decade, with the principal objective of creating single markets for capital and financial service products across the EU. The central element of this reform programme was the ambitious EU Financial Services Action Plan 2000-2005 (FSAP), which included 23 Directives to be transposed into national law between 2002 and 2007. HM Treasury leads on the negotiation of most of the legislation affecting financial services with advice and support from the FSA. The FSA takes part in the committees of regulators known as ‘Lamfalussy committees’, which in turn advise the Commission on legislation. This structure creates a number of constraints on the FSA’s capacity to shape the development of EU financial regulation.

21 The FSA’s role negotiating in Europe was analysed in some depth in the recent National Audit Office review under section 12 of the Financial Services and Markets Act. As such, the review team did not consider it necessary to re-visit this area during the review process. The NAO’s conclusion on the FSA’s European influence was that:

“[FSA] 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”.*¹⁵

Market failure analysis and cost benefit analysis

- 22** The FSA applies a double test for any discretionary regulatory activity it undertakes; it regulates when there is both market failure and the prospect that the intervention will produce net benefits. To help it make this judgement, FSA undertakes market failure analysis (MFA) and cost benefit analysis (CBA).
- 23** The FSA’s CBA and MFA work is led by its Economics of Financial Regulation Department (EFR). The 22 economists within EFR provide advice to policy teams on economic methodology and, being

independent of the policy function, provides a strong challenge function. More detail on its MFA and CBA work can be found below.

Consultation processes

- 24** Prior to its formal consultation process the FSA consults with the Financial Services Practitioner Panel, the Smaller Businesses Practitioner Panel and the Financial Services Consumer Panel. The Panels have the opportunity to probe the FSA’s CBA more deeply and can question FSA officials about their thinking.
- 25** The policy approval process requires high-impact proposals to be presented to the Regulatory Policy Committee, pre-consultation with Panels and clearance from the FSA Board before a Consultation Paper is prepared “in accordance with Plain

Good Practice – Market failure analysis and cost benefit analysis

Market failure analysis (MFA) is an FSA analytical tool that explains the economic case for the FSA’s intervention. Specifically, the FSA is concerned about market failures that pose risks to their statutory objectives. MFA is conducted early in the policy-making process to help the FSA decide whether to begin work on a project that may lead to regulation. The criteria for assessment may be summarised as follows:

- A risk to the FSA’s objectives
- A market failure of some kind
- A regulatory mechanism for offsetting that failure

Once it has been established that there is an economic case for the FSA’s intervention, the FSA assesses whether

the benefits of regulation outweigh the cost. To this end they conduct cost benefit analysis (CBA).

Sections 155 and 157 of FSMA require the FSA to publish an estimate of the costs and an analysis of the benefits that arise from changes in rules and general guidance. Initially high-level CBAs analyse the economic impact of three main factors:

- Impact on firms and their behaviour
- Impact on consumers and their behaviour and
- Changes in the nature of the transactions carried out in the market.

The purpose of the CBA is to help the FSA make an informed decision about whether regulatory intervention is justifiable in terms of the costs of intervention versus the benefits.

¹⁵ The Financial Services Authority: a review under section 12 of the Financial Services and Markets Act 2000, National Audit Office, April 2007, pg28

Language standards”¹⁶ and published on the FSA website. The Consultation Paper includes a description of the proposals, draft amended Handbook text and a summary of the CBA. Following consultation, responses are analysed and set out, along with the FSA’s response in a Policy Statement. The FSA feeds back to the Panels on the consultation process and on how it plans to respond. The Panels’ views must be reported to the Board. Following this, the Board is sent a paper inviting it to approve the policy.

Review Findings

The FSA influences and intervenes effectively in Europe and internationally

- 26** A key factor that affects all regulators when assessing the design of regulation is their ability to proactively engage and influence the European legislative process. As highlighted earlier, the review team did not focus on this area during the review period as the FSA’s international negotiation had been reported on thoroughly by the NAO section 12 report on the FSA, earlier in 2007. The NAO report found that the FSA was proactive at influencing in Europe, and business stakeholders that the review team spoke to echoed this finding. In general, the FSA is perceived widely as one of the thought-leaders in the field of financial services regulation and as having one of the most sophisticated risk assessment systems in place.
- 27** When negotiating around new policy proposals from Europe, the FSA tries to develop a European-level CBA, rather than a UK-specific CBA. This form of analysis carries much more weight in negotiation. The FSA is also involved in attempting to positively influence the culture of European policy-making by running training courses on CBA for interested European parties, sharing their knowledge and experience.

The FSA consults comprehensively with business and consumer groups

28 Feedback from the Panels and other stakeholders we interviewed supported the view that the FSA consults well. However, business stakeholders felt that the consultation period was too extensive and sometimes merely a formality. There was a feeling that the FSA sometimes tended to over-consult, to the extent that businesses felt inundated with information. For example, we were told that in July 07 the FSA had 14 major consultation and discussion papers ongoing at the same time, which caused them to question the strategic approach of the FSA.

- 29** Some smaller business stakeholders were also not clear what happened to the consultation responses that they had made to the FSA. The feedback loop from the consultation process could be improved.

The FSA undertakes market failure analysis and cost benefit analysis for every new piece of policy, although the clarity and accessibility of these could be improved

- 30** The review team found that the FSA generate a substantial amount of market failure analyses (MFA) and cost benefit analyses (CBA) to effectively identify the impact of regulatory interventions and ensure that its regulation is risk-based and proportionate. CBAs and MFAs are undertaken at the start of the policy-making process. As with MFA, the FSA conducts high-level CBAs early in the policy making process to assess whether the regulatory tools it has for correcting the market failure identified could give a fair chance of net benefits. The FSA has made a lot of progress in using its CBA to drive the policy-making process or to stop it early on, rather than preparing a post-hoc justification at the end of the policy-making

¹⁶ The Financial Services Authority – A guide to the FSA’s policy delivery standards http://www.fsa.gov.uk/pubs/foi/policy_delivery.pdf pg 15

process. Our discussion with FSA staff implies that the process is still far from perfect, and that the FSA is keen to raise the quality of this type of ex-ante analysis.

- 31** As explained above, the purpose of a MFA is to explain the economic case for intervention, particularly assessing the risk to the FSA's four statutory objectives. The FSA acknowledges that MFA and CBA is more straightforward when considering wholesale¹⁷ issues but it becomes more difficult when considering retail¹⁸ issues (especially as the FSA's statutory objective for consumer protection then comes into play and other factors such as the behaviour of consumers and different distribution channels have to be taken into account).
- 32** The FSA has commissioned two separate independent research reports to look at its use of CBA, both in terms of the methodology itself, and in terms of the FSA's 'organisational culture' of using CBAs within the organisation. It is working on the recommendations of these reports to improve its processes. Organisationally, there is an issue with turnover of policy staff and the adverse effect this can have on the consistent application and utilisation of CBA throughout the organisation.
- 33** Whilst the FSA's CBA work is usually comprehensive, concerns were raised by stakeholders regarding a full and fair treatment of the costs of new policy proposals. An example of the difficulty with collecting data on costs is the discrepancy between the original CBA for the implementation of the Retail Mediation

Activities Return (RMAR) data return. The FSA originally estimated, following independent market research of 45 firms, that the RMAR would take only 2-4 hours to complete. However, numerous small businesses that we spoke to told us the RMAR in fact took up to 8 hours to complete¹⁹.

- 34** Additionally, there are concerns that can be raised regarding CBA presentation and readability. Stakeholders reported to us that CBAs can be very lengthy, with the costs and benefits of a new proposal not immediately identified upfront. The review team would therefore support the recommendation of the House of Lords Select Committee that the FSA, as with other economic regulators, should look to improve the presentation of its CBAs "with clearer signposting and a commitment to clearness and clarity"²⁰.

The FSA has good challenge processes in place

- 35** For the introduction of new policies or for changes to the FSA Handbook²¹, the FSA has effective internal challenge mechanisms in place. The EFR department provide specific independent economic advice to policy teams.
- 36** Additionally, whenever the FSA proposes a new rule, it is considered by the Regulatory Policy Committee (RPC), subject to some materiality threshold. The RPC reviews significant policy proposals both at an early stage before they are put to the Board and again after consultation, if appropriate. The committee consists of senior management and makes use of high-level CBA and MFA

¹⁷ Primarily business-to-business transactions

¹⁸ Primarily provider-to-consumer transactions

¹⁹ The FSA has recently reduced the number of data fields of the RMAR by 30% as described in the 'Data Requests' section

²⁰ UK Economic Regulators, House of Lords Select Committee on Regulators, 1st Report of Session 2006-07, November 2007 pg10.

²¹ The FSA Handbook sets out the principles and rules with which regulated firms must comply, and provides official guidance

when reaching its conclusions. Its role is essentially one of quality control ensuring only appropriate regulation is introduced or appropriate changes are made.

- 37** The FSA is required by FSMA to consult with two statutory panels – the Financial Services Practitioner Panel (FSPP) and the Financial Services Consumer Panel. The FSA has also set up a Smaller Businesses Practitioner Panel (SBPP), which the FSA has made a commitment to treat in the same way. FSA’s policy processes state that all three panels must be offered pre-consultation on policy proposals before the FSA Board reviews the policy. The panels can make what is known as a ‘Section 11 representation’ if they disagree with a policy the FSA is proposing. The FSA must respond to this in writing. Additionally, for substantive changes to the Handbook, the FSA is required to undertake a consultation process and issue Consultation Papers.

The FSA recognises the importance of undertaking post-implementation work and seeks to do so where resources allow

- 38** Across Government, examples of post-implementation reviews are rare - to a certain extent it can be regarded as the ‘unicorn of regulation’ (in that it is much talked-about, but rarely glimpsed) - but the FSA has actively undertaken some good work in this area. For example, it is currently undertaking a post-implementation review of the Conduct of Business Sourcebook for Investment Business. However, the FSA’s approach to post-implementation review is currently unsystematic and it does not appear to be carried out as a matter of course. The FSA says that it is keen to undertake more ex-post evaluation of new regulations, but sometimes lacks the time or resources to do so.

Good Practice – Regulatory Policy Committee (RPC)

The Regulatory Policy Committee (RPC) allows senior FSA management to review policy proposals at an early stage. The RPC is chaired by the FSA’s Chief Executive sitting with its Managing Directors; General Counsel; the Director of Strategy and Risk; the Director of Enforcement and the Director of Communications.

The RPC reviews all high-profile/controversial consultations and major policy decisions affecting a large number of consumers or financial sectors. For each proposal, a summary of the policy

idea is presented along with the MFA and the supporting CBA that establish an economic case for regulatory intervention.

The Committee decides whether the policy proposals should be developed further, and takes into account the results of the outline CBA. It can decide that policy proposals should not proceed or that the proposals should be revised and presented again.

It is important to note that proposals for new policy are not fully formulated at the stage that RPC see them. This senior-level input acts as an important early challenge function within the FSA.

39 The FSA is developing a more comprehensive review mechanism and this supports its internal performance measurement system²² metrics which relate to whether regulation is proportionate. We would encourage the FSA to place high importance on post-implementation reviews, and to develop a more systematic approach to this work. The EFR department's longer-term programme of economic research is now designed to feed into post-implementation reviews and the Outcomes Performance Report.

40 In making this point, we welcome the recommendations of the House of Lords Select Committee report into the work of Economic Regulators. This made a recommendation that post-implementation review "should be conducted with greater frequency and should always be carried out where a step change in regulatory policy has been implemented"²³. We also support the recommendation that "on occasion an independent body (probably the sessional select committee or the NAO) should monitor the quality of assessments and the objectivity shown by regulators in completing them".²⁴

²² The Outcomes Performance Report (OPR), discussed further in the 'Focus on Outcomes' section

²³ UK Economic Regulators, House of Lords Select Committee on Regulators, 1st Report of Session 2006-07, November 2007, paragraph 4.76, page 46.

²⁴ UK Economic Regulators, House of Lords Select Committee on Regulators, 1st Report of Session 2006-07, November 2007, paragraph 4.76, p46

Advice and guidance

Hampton principle

“Regulators should provide authoritative, accessible advice easily and cheaply.”

Key findings

- The FSA is better at communicating with larger firms than smaller firms
- However, the FSA is improving its advice and guidance channels to small firms
- The Firms Contact Centre is an under-exploited resource for giving advice and guidance to small firms
- The FSA’s move towards More Principles-Based Regulation will require it to strike a balance between providing better advice services without straying into becoming a consultancy service

Background

- 41** The FSA has set out 11 Principles for Business which summarise the high-level requirements for firms under the regulatory system. The principles are statutory and enforcement action can be taken on the basis of them.
- 42** The Principles are complemented by an 8,000 page Handbook of Rules and Guidance (the FSA Handbook). The Handbook contains the specific rules that account for 80% of the administrative cost that the FSA imposes on business through regulation. The Handbook is available online in HTML or PDF formats, or on CD-ROM and can be tailored for different types of businesses.
- 43** The FSA is seeking to reduce the emphasis placed on its detailed Handbook rules, replacing them with short high-level outcome-focused requirements, often accompanied by regulatory guidance. This revision of its rules and guidance is seen by the FSA as an ongoing process, in its Business Plan for 2007/8, it talks of an ongoing drive toward **“more principles-based regulation” (MPBR)**. This will require a shift in emphasis for the organisation, with greater reliance on general principles rather than specific rules.

Advice formats

- 44** The FSA provides advice and guidance to business in a number of ways. These include:
- Press Releases
 - Speeches
 - The FSA Handbook
 - Visits
 - Firm Contact Centre
 - Roadshows
 - Surgeries
 - Newsletters

Small Firms and Firm Contact Centre

- 45** 95% of the firms the FSA regulates are small firms. The compliance of these smaller firms is mainly monitored by the FSA through 6-monthly regulatory returns, rather than a formal inspection process. Larger firms are monitored under a different supervisory system (described under the ‘Inspections’ section).
- 46** The point of contact for these 17,500 small retail firms who do not have an individual FSA supervisor is through the Firms Contact Centre (FCC). The FCC has a budget of around £1.5 million a year and approximately 40 staff.

47 In terms of penetration of the small firms market, the FCC received 11,753 contacts in October. These contacts came from 5,602 firms. Of this figure 3,044 were small retail firms. This represents a population of 12.6% of the total population of firms the FSA regulates²⁵ (excluding mutual societies and UKLA firms). The FCC sees 'peaks and troughs' of activity relating to the submission of 6-monthly returns.

Treating Customers Fairly initiative

48 Since 2005, the Principle of Business relating to fair treatment of customers has been the subject of a major drive by the FSA. The Treating Customers Fairly (TCF) initiative aims to raise standards in the way firms carry on their business by introducing changes that will benefit consumers and increase their confidence in the financial services industry. The FSA has set out six TCF outcomes which it expects the industry to achieve:

- 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 takes account of their 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

Good Practice – Business Simulation course for Small Firm supervisors

One of the recently introduced modules of the FSA's ARROW II training programme for supervisors in their Small Firms Division (SFD) is a Business Simulation course which has been running for the last six months. The courses are intended to give supervisors a real sense of how small firms react to supervisory visits. The FSA uses a pool of industry practitioners and 'grey panthers' (retired senior executives) to take on the roles of firm management in mock scenarios.

Courses are run on a monthly basis and delegates are invited to attend, based on individual development needs.

In addition, the FSA also offers training and Breakfast Briefings to the larger firms to prepare for their ARROW visits. Feedback from these events has generally been positive and firms have indicated that they have assisted them in their preparation for an ARROW visit from the FSA.

The FSA will be expanding this in 2008 with ARROW II Forums where representatives can ask the FSA ARROW team any questions they may have about ARROW.

²⁵ FSA Firm Contact Centre statistical analysis – October 2007

- Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

49 TCF is one of the most high profile 'Principles' as it was one of the earliest to be tied into the 'more principles-based regulation' (MPBR) approach and used in enforcement cases. The TCF initiative is nearing its deadline for final implementation in December 2008. It is a Principle which firms are still particularly vocal about even though the FSA has been offering advice and guidance on it since July 2006. The FSA does not lay down any standard way in which TCF should be assessed and implemented, but it does provide information and support.

Review Findings

The FSA is better at communicating with larger firms than smaller firms

50 The level of explanation from the FSA about why it is intervening, how it is intervening and what the intervention will be can vary according to firm size. Because of the 'close and continuous' supervisory relationship (discussed in the 'Inspections' section), larger firms are more likely to be 'in the loop' regarding new FSA initiatives and policy, and are likely to have the resources required to engage on the regulatory issues. Smaller firms generally do not have the resources at their disposal and need to be more proactive about finding information on the FSA website such as looking at speeches, press releases or consultation/discussion documents.

However, the FSA is improving its advice and guidance channels to smaller firms

- 51** The FSA acknowledges that it needs to do more to provide advice and guidance to small firms, developing a package of communication approaches tailored to their needs. For example, it has specific pages on its website that are dedicated to small firms which contain online tools, good and poor practice guides and factsheets. As a part of this it has also developed a 'hot topics' FAQ section that gives answers to the most commonly received queries into the FCC. Additionally, FSA hosts regular small firms 'roadshows' around the country, usually on a specific subject, such as TCF or More Principles-Based Regulation. FSA also sends a monthly e-mail bulletin to all its small firms, called "regulation round-up", which allows firms to access changes to rules which relate specifically to their sector; and places articles in trade press.
- 52** An independent survey of 1,000 firms in the summer of 2007 showed significant progress, for example, 93% of those surveyed had visited the Small Firms website in 2007 and 67% found it easy or very easy to use. The FSA is currently enhancing its small firms strategy to help firms make faster progress towards treating customers fairly, and this will also help respond to the feedback from small firms which highlighted that they wanted more direct contact with the FSA. The review team feels that the FSA is on a good trajectory and we would encourage the expeditious development of its small firms' strategy, part of which includes an increased number of supervisors for small firms.

The Firm Contact Centre is an under-exploited resource for giving advice and guidance to small firms

- 53** The Firm Contact Centre (FCC) is a dedicated advisory resource for all firms, but particularly for small firms. The FCC handles telephone and written communications and queries from firms to help them understand the FSA's regulatory requirements. It is intended to provide help for business, but it is not intended as a substitute to help firms manage their business. The FCC mainly provides advice in the form of 'signposting' callers to relevant published information (such as the FSA Handbook) and is primarily a reactive service that relies on responding to issues that are brought up.
- 54** The FSA wants to move the FCC to a more advisory service by 2010. Its vision is to support the FSA's move to MPBR through providing a proactive advice service. For example, when a new firm comes into scope of regulation, FCC would contact it directly and introduce itself to the firm.
- 55** The review team found that FCC staff displayed a good knowledge of FSA systems and processes and were able to resolve or deal with a wide range of queries in an efficient and effective manner. However, we found highly competent advisors spending a great deal of time dealing with low level information requests. An estimated 41% of calls²⁶ to the FCC in October were queries or issues relating to completion of the FSA's regulatory returns. We suggest that improving the clarity of the FSA's data returns could free up FCC staff to act in a more advisory manner.

The FSA's move towards More Principles-Based Regulation (MPBR) will require it to strike a balance between providing better advice services without straying into becoming a consultancy service

- 56** The move to 'more principles-based regulation' will mean a significant shift in emphasis with greater reliance on principles and less on specific rules. As the recent NAO section 12 report highlighted, a move to a more principles-based approach means:

"...placing greater reliance on firms adhering to its higher level principles, and a greater focus on the outcomes firms achieve for consumers and markets.. 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. 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."

"Principles-based regulation is most successful when it is used to mediate a relationship. The FSA's risk-based

²⁷ The Financial Services Authority: a review under section 12 of the Financial Services and Markets Act 2000, National Audit Office, April 2007, pg 5

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.”²⁷

- 57** The FSA acknowledges that a principles-based approach may mean more uncertainty for firms about the detailed processes needed to achieve regulatory outcomes. In particular, the principles-based move will have an impact on smaller firms, which make up 95% of the firms that the FSA regulates (but 2-3% of the market in terms of revenue). The FSA recognises that it will have to go further in offering advice and guidance to smaller firms. However it is not intending to offer a free consultancy service and is looking to alternative approaches such as guidance written by practitioners for use by firms.
- 58** MPBR nevertheless presents an interesting challenge for the FSA in that the amount of direct supervisory contact between smaller firms and the FSA may increase. There is a risk that this regulatory relationship may slide over into consultancy, or that the FSA may get involved in giving advice to firms outside of their specific regulatory remit (such as advice regarding the running of a firm). The FSA needs to think carefully about the skills needed in the move to MPBR, and also to think about the types of training and internal challenge functions that it will need to put in place to ensure that its advisory approach does not go too far and compromise their independence as a regulator.

Data requests

Hampton principle

“Businesses should not have to give unnecessary information or give the same piece of information twice.”

Key findings

- The FSA’s main data return is lengthy and complex, this causes difficulties particularly for smaller firms
- The FSA is aware of this issue and plans improvements to its regulatory reporting regime
- Business stakeholders are unclear about what the FSA does with the data it collects
- Some aspects of the FSA’s current data collection requirements for small firms appear excessive, especially given the FSA’s overall risk-based approach to regulation
- The FSA is exploring the benefits of data sharing

Background

59 The FSA has a number of different data returns depending on the regulated activity, which it requires firms to complete from time-to-time. The three main data returns for firms engaged in mortgage lending and advice (financial, mortgage, general insurance) are:

- Mortgage and Lending Activities Return (MLAR)
- Retail Mediation Activity Return (RMAR)
- Complaints Return

60 The RMAR and MLAR were brought in at the introduction of the mortgage and general insurance regime, replacing the previous reporting requirements by financial advisers. The FSA has undertaken a post-implementation review of the RMAR and Complaints Return. The FSA has reduced the number of data fields of its Complaints Return by 80%, of the RMAR by 30% and has deferred the review of the MLAR until 2008/09. During the review, the team focused on the regulatory regime for small retail firms and the RMAR given its

important role in the FSA’s risk analysis and as a key supervisory tool for smaller firms.

61 Nearly 18,500 firms submit the FSA’s RMAR form at 6-monthly intervals. 86% of these are smaller firms (which FSA defines as having an annual income of less than £5 million per year). When mortgage and general insurance firms came under the FSA’s remit in 2004/05, the number of regulated firms increased by 14,300 and in the last few years, more activities have come within the scope of regulation by the FSA, thereby increasing in general the number of firms from whom data is requested.

62 The FSA started the Integrated Regulatory Reporting programme (IRR), in 2003/4 and this has helped to support its move to MPBR by ensuring that:

- the FSA only requires firms to submit data that provides information that the FSA uses
- the FSA aligns regulatory reporting with the information that firms use for their own internal monitoring

- the FSA uses its influence within the EU so that any common reporting frameworks are risk based and
- the FSA invests in technology to collect and validate the data in the most efficient and effective way.

Review Findings

The FSA's main data return is lengthy and complex, and this causes difficulties particularly for smaller firms

- 63** The FSA's main data return, the Retail Mediation Activity Return (RMAR), is lengthy and complex. Smaller business stakeholders we talked to estimated that the return can take up to 8 working hours to complete. Any firm that has permission to undertake mortgage mediation, insurance mediation, and/or retail mediation activity is required to submit the RMAR form to the FSA at 6 monthly intervals²⁸. The length and complexity of the form can be a contributing factor to queries to the FSA. In October 2007, 41% of calls to the FSA's Firm Contact Centre (FCC) related specifically to regulatory reporting. The majority of these calls related to problems filling in the form or accessing the website.
- 64** The FSA uses data from the return to build an overall picture of the market and to generate alerts of particular issues that require further investigation using its risk-based systems Advanced, Risk-Responsive Operating FrameWork (ARROW) and Alert and Risk Indicator (ARI).

The FSA is aware of this issue and plans improvements to its regulatory reporting regime

- 65** The FSA has coped well with synthesising the reporting regimes of the 11 precursor regulators, and has made good strides on

e-enablement of its forms. The RMAR, in particular, is a 'smarter' form in that it tailors itself depending on the type of firm that is completing it and eliminates unnecessary fields on the basis of answers that are given as the form is filled in, saving a firm's time from checking whether redundant sections apply.

- 66** Overall, the FSA has an impressive vision for data collection through the Integrated Regulatory Reporting programme (IRR). The reviews carried out since 2004 of the various data regimes it inherited have streamlined the regulatory reporting requirements. These reviews have covered reporting by banks, building societies, securities and investment management firms who do not submit financial data through the RMAR. It has put in place a rigorous formal internal data challenge process requiring a cost benefit analysis so that data is collected only if there is a need for it where it can be used as an effective supervisory tool and data capture is also reviewed every 2-3 years.

Business stakeholders are unclear about what the FSA does with the data it collects

- 67** During the review, we found evidence that business stakeholders do not fully understand the reasons why the FSA is collecting data and how that information is used. We believe that the FSA should do more to draw businesses attention to how it makes use of the data that it requests and firms submit (i.e. for identifying issues at individual retail investment firms and for market analysis). The use of the data for market analysis is beneficial both to the FSA and the industry as thematic issues that are causing problems can be flagged up and resolved through the FSA's thematic supervisory approach. This ensures both increased service standards for the

²⁸ Although larger firms (generating more than £5million per year in relation to retail mediation activities) are required to report financial information quarterly

consumer and good business practice and hence improved customer satisfaction for firms.

Some aspects of the FSA's current data collection requirements for small firms appear excessive, especially given the FSA's overall risk-based approach to regulation

- 68** The FSA's approach to data collection for small firms appears to be at odds with its culture of being risk-based. Given that small firms collectively pose a small risk to the FSA's statutory objectives (representing 2% of the market in terms of revenue but 95% in terms of total firms population), we question whether a more proportionate system could be capable of achieving a more streamlined, risk-based process.
- 69** For example, the FSA could undertake sampling of smaller firms on a risk-basis. Taking a representative sample of the small firms market has the potential to reduce the total administrative burden on all small firms, as only a percentage of them would be submitting data – depending on the FSA's risk profiling of the sector.
- 70** The review team would encourage the FSA to explore the benefits (and costs) of a risk-based approach to sampling data from the 17,500 small retail firms that it regulates, as opposed to surveying all firms every 6 months for completeness.

The FSA is exploring the benefits of data sharing

- 71** The FSA is actively engaged in data sharing with the Financial Ombudsman Service (FOS), the Office of Fair Trading (OFT) and the Bank of England. The aim is to ensure that the same information is not requested from firms more than once. Dataflow from FOS is increasing and on a more regular basis. For example the FSA compares the information it receives from firms via Complaints against Financial Ombudsman Service (FOS) complaints data as a validity check.

Inspections

Hampton principle

“No inspection should take place without a reason.”

Key findings

- Business generally has a positive view of FSA supervisory visits
- The FSA’s risk analysis methodology is a systematic analytical tool that allows it to target interventions effectively
- However, the rationale for the allocation of resource between ‘firm-specific’ and ‘thematic’ supervision is unclear
- The FSA experiences significant staff turnover in key supervisory grades, which can negatively affect the consistency and quality of the supervisory relationship
- The FSA’s broad objectives potentially encourage supervisory focus on areas that are not specifically regulatory issues
- There is a lack of feedback for smaller firms that are selected for thematic review
- The FSA’s regulation of larger firms can be characterised as ‘regulation through dialogue’
- The FSA seeks feedback from firms on their supervisory approach but this is not used in a comprehensive manner

Background

72 There are two key concepts underlying the FSA’s approach to inspections: **authorisation and supervision**. ‘Authorisation’ refers to the initial approval and provision of a license to operate for companies and individuals. ‘Supervision’ is the term the FSA uses to describe its day-to-day regulatory relationship with authorised firms. Most of the FSA’s action to secure regulatory compliance is supervisory intervention day-by-day to ensure that firms understand their obligations and make the necessary changes to their business to comply with these objectives. It is this aspect of the FSA’s regulatory role that we assessed against the criteria of ‘Inspections’.

Risk-assessment

73 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 assesses the risk posed to achieving its objectives by events, issues and firms. A single risk assessment is made for each firm (or group of firms). The risk assessment is based on an estimation of the probability of a risk ‘crystallizing’ (that is, becoming realised) and the effect of that realised risk on the FSA’s objectives.

74 The FSA’s risk assessment framework is called ARROW (Advanced, Risk-Responsive Operating FrameWork). This system shows where the FSA should focus supervisory activity. For more information on the risk assessment system, see below. Within ARROW, there are two basic approaches to supervise firms:

- The ARROW Firms approach – used when assessing risks in individual firms (the FSA calls this **‘vertical’ supervision**); and

**Good Practice
– ARROW Risk-assessment system**

The FSA’s Advanced Risk-Responsive Operating FrameWork (ARROW) was first introduced in 1999/2000 around the time the FSA was created and its effectiveness was reviewed in 2003. A revised ‘ARROW II’ framework was rolled out in 2006.

ARROW aggregates a series of judgements about the risk levels for each firm for the following elements (with typical examples):

- Environment risks (economic, legislative, competitive)
- Business model risks (people risks, IT systems, credit and liquidity risks)
- Controls (accepting customers, market conduct controls, IT security, security of client money, credit risk controls)
- Oversight and governance (compliance monitoring, corporate governance, strategic planning, culture and management)

The nature and extent of the FSA’s supervisory relationship with an individual firm depends on how much of a risk the FSA considers it poses to its statutory objectives. The base level of supervisory intensity depends on impact and probability scores assigned to a firm (or group of firms) which, in turn, helps to determine the nature of the relationship that FSA has with a particular firm.

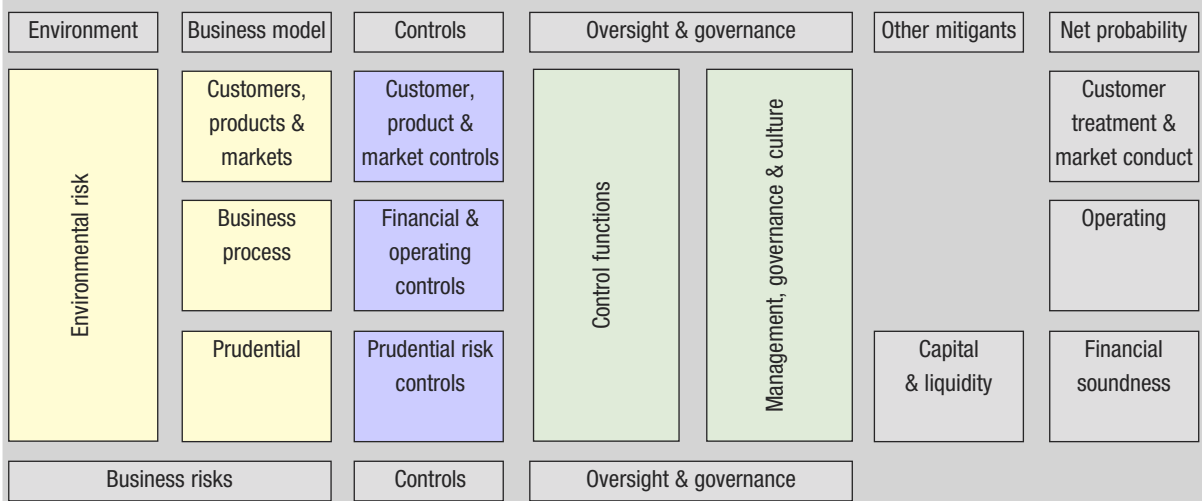
High impact – ‘close and continuous’.
Regular periodic assessments
(c.90 firms)

Medium high impact – regular visits.
Regular periodic assessments
(c.420 firms)

Medium low impact – occasional visits.
Regular reduced scope periodic assessment (c.900 firms)

Low impact – data collection/call centre/targeted topics/visits
(c.27,560 firms)

ARROW risk model



- The ARROW Themes approach – used when assessing cross-cutting risks (i.e. those involving several firms or relating to the market as a whole (the FSA calls this **'horizontal' supervision**).

To summarise, 'vertical supervision' is the day-to-day supervisory process with larger firms, focusing on the risks in specific firms. 'Horizontal supervision' is a more proactive process that usually involves the probing of new and emerging risks that are market-wide and more cross-cutting. An example of this would be the FSA's work on Payment Protection Insurance.

Supervisory approach to Larger Firms

- 75** For high impact firms, the FSA applies a **closer monitoring regime** (called **'close and continuous'**). These types of firms are generally very large organisations that operate internationally (such as HSBC, HBOS, Barclays). As they are so large and complex, a 'supervisory team' is allocated to their supervision (for example, the largest international groups may have up to around six team members). The 'close and continuous' relationship includes a planned schedule of ARROW visits to the firm

throughout the regulatory period, which allow the supervisory team to meet the firm's senior management and control functions regularly. This can include meetings with Non-Executive Directors.

- 76** With medium and high-impact firms, the FSA coordinates its work through a **relationship manager**, who carries out a regular risk assessment and determines a risk mitigation programme to manage the risks identified.

Supervisory approach to Small Firms

- 77** The FSA believes that most small firms pose a low risk to their objectives individually. As a result, small firms have a less resource intensive and lighter-touch supervisory relationship with the FSA. In practice this means, unlike the larger firms, they do not have regular visits and are required to send regulatory reports (such as the RMAR) twice a year (with the exception of credit unions who have separate reporting requirements). Small firms are given the Firm Contact Centre (FCC) as a primary contact rather than a relationship manager.

Good Practice – Firms and Markets Committee (FMC)

This committee is a part of the FSA's rigorous internal arrangements to keep a watching brief across supervisory areas. The FMC is made up of senior FSA management and it meets on a weekly basis for three purposes:

- to facilitate sharing on regulatory issues and cases of major

significance between senior management – using weekly reports from each area of the organisation as a basis.

- To review, on a monthly basis, the 'watchlist' of firms that represent a significant risk to the FSA objectives.
- To consider matters on individual firms or wider firms/markets that the FSA might need to bring to the attention of HM Treasury.

- 78** The FSA follows up alerts raised in respect of individual firms (e.g. from the RMAR) and will take action against individual firms when serious regulatory breaches are identified. In parallel with this, the FSA believes small firms can pose a risk to their objectives collectively, for example, through extensive mis-selling in a particular sector, or of a particular product. To regulate the 17,500 small retail firms the FSA collects information from a number of sources (e.g. RMAR) and analyses the data to identify collective risks. Where there are emerging collective risks, the FSA investigates the matter further (e.g. questionnaires or targeted firm visits) and then communicates the results of the exercise to the industry (e.g. web pages, media and national events such as road shows). The aim is to change the behaviour of small firms in a way that improves standards across the industry.

Review Findings

Business generally has a positive view of FSA supervisory visits

- 79** Business stakeholders consulted during this review were positive about engagement with the FSA supervisory staff; this was markedly so amongst representatives of smaller firms that had experienced a supervisory visit from the FSA. We are pleased to note that the FSA is planning to invest more resource in the supervision of small firms. The FSA has emphasised to us that part of the reason for the increased supervision effort on small businesses is to combat a sense of disengagement, in particular among the Independent Financial Advisor community.
- 80** We found that the FSA preparation for supervisory visits (both thematic and vertical) was thorough, targeted and challenging. However, some stakeholders thought that the FSA supervisory approach could be rigid at times, and did not allow much room for flexibility on the part of the supervisor.

The FSA's risk analysis methodology is a systematic analytical tool that allows it to target interventions effectively

- 81** The FSA ARROW risk-analysis is systematic and is developing. The revised ARROW II framework was rolled out in 2006. The review team were highly impressed with the level of market segmentation analysis that the FSA is able to conduct and the way the analysis can support a targeted regulatory approach.

However, the rationale for the allocation of resource between 'firm-specific' and 'thematic' supervision is unclear

- 82** During the course of the review, we found no clear answer as to how the FSA chose to allocate resource between 'vertical' (or firm specific) supervision and 'horizontal' (or thematic) supervision. The review team were unable to establish the rationale or evidence base behind the current level of allocation of resource between the two types of supervision, which appears to rely on informed FSA management judgement rather than a specific methodology.
- 83** Similarly, the rationale for the allocation of resource between supervision and policy is unclear. The review team received feedback from stakeholders that a lack of strategic focus on priority issues led to the FSA intervening in a great number of areas rather than prioritising 5 or 6 key areas which would yield better results. The FSA have a budget process at Director and Managing Director level to assess the portfolio of risk in each area using the information available to them before assessing which risks to mitigate (and which not to mitigate) and hence what resource is required. The process drives the production of the FSA annual business plan and budget.

The FSA experiences significant staff turnover in key supervisory grades, which can negatively affect the consistency and quality of the supervisory relationship

- 84** A criticism from business in this review was around the high-level of turnover of supervisory staff. The view of business was that there was a lack of consistency in their regulatory contact point and, as a result, this meant that they had to regularly spend time explaining to the supervisor how their firm operated. Another concern was that high turnover meant that the new supervisors did not appear to have the skill-set to undertake 'more principles-based regulation' and were focusing their attention on regulatory minutiae.
- 85** The FSA's external staff turnover is 13%, which is around the industry average, but its internal and external turnover (combined) can be as high as 25%. Whilst there appears to be a lack of metrics on how long supervisors stay with a particular firm, the FSA estimates that within its Retail Firms Division (RFD), it is unlikely that a relationship manager will supervise the same firm over a 3 year period. The FSA agrees that the length of time a supervisor interfaces with a firm is not as long as it would like. A factor that plays into this is that the FSA try to make sure that supervisors don't stay with the same firm for too long a period to avoid the possibility of regulatory capture, as well as moving people internally for career development reasons.
- 86** A major reason for the degree of external turnover is that the FSA regulatory staff have a high-degree of directly transferable skills within their regulated community. Staff transfer from the FSA to the financial sector (particularly areas supervising larger firms) is a major element of turnover, and

these transfers tend to be experienced and good quality staff.

- 87** Whilst one could argue that industry is complicit in creating this issue, the FSA has tried to reduce the 'pull' of the private sector – for example it has upgraded the role of the FSA relationship manager with enhanced seniority as part of its move to more principles-based regulation, and it looks to apply retention bonuses proactively.

The FSA's broad objectives potentially encourage supervisory focus on areas that are not specifically regulatory issues

- 88** The FSA's four statutory objectives are high-level and widely framed. On top of this the FSA process of 'vertical supervision' (or relationship management of a firm), requires the supervisor of a firm to have a detailed knowledge of the workings and changes to the business plan of the organisation they are managing. As a result, potentially any area of activity of a firm could be of interest to a supervisor, and there is a danger that that this could encourage the supervisor to take a 'shadow management' approach towards the firm in question. By this we mean getting routinely involved in issues around a firm's organisational or business strategy.
- 89** During the review, we came across examples where the line between what are regarded as regulatory issues, and what are regarded as firm management issues appeared to be blurred. On the whole however, the FSA is alive to this issue and has internal challenge processes, such as the formal ARROW Panel process, in place to mitigate against this risk. We note this as an issue for the FSA to bear in mind, particularly in light of its move to MPBR. It is also important to note in the light of Northern Rock that the FSA is under

²⁹ We understand that the FSA's Director of Internal Audit has now begun a review to ensure that the FSA learns the lessons from the Northern Rock events, including for its risk-assessment and risk-mitigation practices as a whole www.fsa.gov.uk/pubs/other/memo_TSC.pdf

pressure to focus to a greater, not lesser, extent on firms' business plans²⁹.

There is a lack of feedback for smaller firms that are selected for thematic review

- 90** The review team found evidence from smaller firms that they had not received feedback as a matter of course from the FSA on visits that it undertakes in the course of its thematic supervision work. Whilst outcomes of thematic work are useful to help improve compliance in a sector, providing individual feedback to firms that have been involved in the thematic process would be more transparent.

The FSA's regulation of larger firms can be characterized as 'regulation through dialogue'

- 91** The FSA's 'close and continuous' relationship with large firms is a formal regulatory process. It includes a series of risk-assessment visits and risk-mitigation letters to the organisation.
- 92** The review team were struck by the very different style of approaches of the FSA to small and big businesses. Currently, the 'close and continuous' relationship that the FSA has with very large firms allows for firms to have access to a named contact in

the regulator that they can call to deal with any regulatory query they may have. To an extent this encourages informal contacts to supplement formal interaction and as a result, the close and continuous relationship tends towards an ongoing regulatory dialogue.

- 93** Smaller firms, however, have access to the FCC, and the advice they get is in the form of 'signposting' rather than firm-specific advice. The FSA's initiatives such as its small firms strategy and its move to More Principles Based Regulation signal a shift in this differentiation of approach to advice provision and, as mentioned earlier, has the potential to bring a larger number of firms into regular regulatory contact with the FSA.

The FSA seeks feedback from firms on their supervisory approach but this is not used in a comprehensive manner

- 94** Whilst the FSA does undertake some activity to monitor firm satisfaction, we were surprised that more reference was not made to this by FSA staff during the review. We found no evidence that the findings of this work are being used in any obvious way to drive changes in regulatory behaviour.

Sanctions

Hampton & Macrory principles

“The few businesses that persistently break regulations should be identified quickly, and face proportionate and meaningful sanctions.”

“Regulators should be transparent in the way in which they apply and determine administrative penalties.”

“Regulators should avoid perverse incentives that might influence the choice of sanctioning response.”

“Regulators should follow up enforcement actions where appropriate.”

Key findings

- The FSA’s supervisors have a number of tools available to encourage firms to improve their behaviour
- Levels of formal enforcement action are relatively low
- The FSA’s supervisors prefer to fix problems regarding firm behaviour by the most pragmatic route, and do not automatically pursue enforcement
- We believe that the FSA needs to ensure that an appropriate balance is achieved in the use of different sanction options
- The FSA is keen to do more on criminal sanctions and wants to increase its levels of fines

Background

Sanctioning powers

95 The FSA has civil, criminal and disciplinary powers. These include financial penalties, removal of authorisation or criminal prosecutions (for cases of market misconduct). FSMA allows the FSA to take action such as:

- withdrawing or varying an authorised firm’s permission to carry on regulated activities;
- imposing financial penalties or public censures on authorised firms and people approved by the FSA to work in those firms;
- imposing penalties for market abuse;
- applying to the Court for injunction and

restitution orders; and

- prosecuting various offences.

96 The FSA also has powers to prosecute under the insider dealing provisions of the Criminal Justice Act 1993 and the Money Laundering Regulations 2007. FSMA gives the FSA the power to interview people and the power to require them to provide information and/or produce documents.

97 The FSA also investigates people who are carrying on regulated activities – such as accepting deposits or giving investment advice – without authorisation. This is described as a breach of the general prohibition. These can be prosecuted through criminal proceedings.

Organisational structure of the Enforcement Division

- 98** The FSA's Enforcement Division is not a part of the three business units of the FSA (Retail Markets, Wholesale Markets and Regulatory Services). It operates across the business units and reports directly to the chief executive. The Enforcement Division includes three Retail departments, a Wholesale department and a Legal department. There are approximately 240 staff in the Enforcement Division made up primarily of forensic investigators and lawyers.
- 99** The FSA's Enforcement objective is to change the behaviour of firms and individuals operating in the financial services market. This means that the FSA's enforcement action should have both a deterrent effect and be punitive for those who have engaged in misconduct. The FSA states that it needs to pick the right cases for formal investigation from a large number of potential breaches. Cases referred to the Enforcement Division will tend to be serious in nature and in taking action, the FSA's objective is to send a message to industry that it regards the behaviour in question as unacceptable. In

this sense, enforcement activity has a wider educational purpose.

- 100** Each year the FSA determines its enforcement priorities to enable it to achieve its strategic aims. Thus there is a clear link between the focus of enforcement activity and the strategic messages the FSA wishes to send.
- 101** Once a case is referred to the Enforcement Division, Enforcement staff prepare and recommend action on individual cases. These are then considered by a separate Committee of the FSA, called the Regulatory Decisions Committee (RDC). The RDC takes enforcement, authorisation and supervisory decisions. It is appointed by and reports directly to the FSA Board. It is intended to provide the separation required by FSMA of investigations and recommendations from the decision-taking and issuing of statutory notices. Members of the RDC are drawn from current and recently retired practitioners and non-practitioners.

Settlement procedures

- 102** Following the outcome of the Enforcement Process Review, led by David Strachan in

Good Practice – Supervision Enforcement Referral Forum (SERF) Panel

The Forum is a part of FSA's internal procedures that aims to promote consistency in referral of cases, share good practice on the enforcement referral process and take forwards the recommendations of their internal Enforcement Process Review.

The group meets once a quarter and is made up of senior managers from each FSA division that refers cases to

enforcement (Major Retail Group, Retail Firms Division, Small Firms Division, Financial Promotions, Markets, Wholesale Firms and Retail Themes), and senior Enforcement staff.

The group discusses referrals made to ensure that lessons are learned, to ensure that feedback from the accepted and rejected referrals is communicated and that both enforcement and referring areas are adopting a consistent approach.

2005, the FSA introduced new executive settlement procedures³⁰ in 2006. In 2006/07 most enforcement cases were settled before reaching the Regulatory Decisions Committee – two-thirds of disciplinary cases settled and all cases involving a financial penalty settled during the first settlement phase, receiving the full 30% discount on the financial penalty.

- 103** All settlement decisions are made by two senior members of the FSA staff. The RDC is the decision-maker for enforcement matters which do not settle. RDC members come from a wide range of backgrounds reflecting the interests of industry and consumers. The independent Financial Services and Markets Tribunal handles appeals in the decisions process for those who do not agree with the RDC’s decision.

Review Findings

The FSA’s supervisors have a number of tools available to encourage firms to improve their behaviour

- 104** The FSA is slightly unusual in that its enforcement arm is separate from its ‘inspection’ activities – that is, the supervisors of firms. There are thus a number of ‘sanctioning options’ which fall into the remit of supervisors without the need to go to Enforcement. It is helpful to consider the FSA’s enforcement options as falling into two broad hierarchies illustrated below.
- 105** There are powerful sanctions that an FSA supervisor can call upon that do not require

Figure 1: FSA sanctioning options

Severity	Enforcement tools	Supervisory tools
High	Criminal Prosecution	
	Removal of Authorisation/Approval/Prohibition Orders	Variation of permission (own initiative variation of permission)
	Financial Penalties/Public censures	S.166 Skilled Persons Report/ Past-business review
	Private Warnings ³¹	Letter to Board
		Supervisory Discussion
Low		No action

³⁰ These procedures are different to ‘out of court’ settlements in commercial contexts. An FSA settlement is a regulatory decision, taken by the FSA, the terms of which a firm accepts. There is a 30% discount for firms that settle in the ‘first settlement phase’.

³¹ Private Warnings are written notifications from FSA to a firm or individual that, despite having concerns about their behaviour, FSA has decided that it is not appropriate to bring formal disciplinary action. They are a more serious form of reprimand than would usually be made in the course of ongoing supervisory correspondence. Since April 2005, 83 Private Warnings have been issued across FSA.

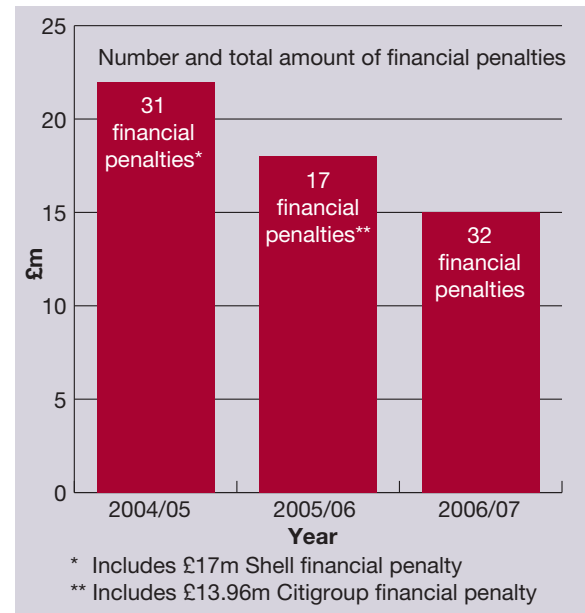
the case to be referred to the Enforcement arm of the organisation. A section 166 report, for example, can have a more severe and immediate impact on the firm than some of the pure enforcement options. Section 166 of FSMA, which gives the FSA the power to commission 'reports by skilled persons' (paid for by the firm itself), is used by the FSA to gain an independent view of aspects of a firm's activities which are causing concern.

- 106** The FSA used this power in 18 cases in 2006/07 (2005/06: 17). The total estimated cost to the firms and individuals covered was £3.8 million (2005/06: £3.7 million). Estimated costs per report ranged from £2,000 to £750,000 (2005/06: £400 to £976,000). As can be seen, the level of impact of section 166 reports can be equivalent to a large financial penalty. The Enforcement Operation in turn has a number of tools ranging from Criminal Prosecutions at one end to Private Warnings at the other.

Levels of formal enforcement action are relatively low

- 107** In 2006/07 32 enforcement cases involved financial penalties of £14.66 million. The total amount of the FSA financial penalties has declined over the past three years from a high point of £22.5 million in 2004/05³².
- 108** Compared with another major international financial regulator, the US Securities and Exchanges Commission (SEC), enforcement is a relatively small part of the FSA's activity. FSA's Enforcement Division accounts for around 8% of FSA resource, whereas it accounts for nearly 40% of the SEC's.

Figure 2: FSA financial penalties³³



The FSA's supervisors prefer to fix problems regarding firm behaviour by the most pragmatic route, and do not automatically pursue enforcement

- 109** As described in the 'Inspections' section, 'supervision' is the term the FSA uses to describe its day-to-day regulatory relationship with authorised firms. It is a process of monitoring firms to ensure they are complying with the regulatory requirements, including the 11 principles set out by the FSA, and that the firms do not pose an undue risk to the FSA's statutory objectives. With high and medium-impact firms, the FSA coordinates work through a relationship manager (a supervisor), who carries out a regular risk assessment and determines a risk

³² As Figure 2 shows, a £17 million penalty was imposed against Shell in August 2004, and a £13.9 million fine was imposed against Citigroup Global Markets in June 2005. These remain FSA's two largest fines to date

³³ FSA Annual Report 2006/07, pg 137

mitigation programme proportionate to the risks identified.

- 110** In our discussions with supervisors it appeared that they were primarily concerned about achieving a satisfactory outcome to issues that arise in the course of regulatory interactions with firms. The risk of a firm not complying with FSA rules is ‘owned’ by the relationship manager. Their incentive and preference is therefore to try to ‘fix’ a given situation rather than thinking about the ‘demonstration effect’ that enforcement action could bring. As supervisors weigh up the tools available to them, they will be conscious of the need to balance a speedy, efficient outcome with the importance of the demonstration effect. Even where a sanction is appropriate, it may be more expedient to choose a sanction from within the supervisory tools (see figure 1) rather than developing an enforcement case – which can sometimes be lengthy, and may have an uncertain outcome.
- 111** As a result, the FSA’s supervisors prefer to fix problems with firm behaviour by the most efficient route, and do not automatically pursue enforcement. We want to emphasise that this is by no means a criticism. Rather it is a positive feature of the FSA’s regulatory approach: the staff focus on how to achieve the outcome of behaviour change by the most efficient route. Nevertheless, we consider some consequences of this approach in the following section.

We believe the FSA needs to ensure that an appropriate balance is achieved in the use of different sanction options

- 112** The FSA states that it is “absolutely not an enforcement-led organisation”³⁴. The FSA takes enforcement “either because the breach was so egregious and there was serious consumer detriment or serious market abuse has been committed and/or...[FSA] feel it is very important to send a message to the other people operating in that sector that ... behaviour is unacceptable.”³⁵
- 113** A striking feature of this review was how ingrained the FSA statement ‘not an enforcement-led regulator’ was amongst staff that we talked to. It also manifested itself in the FSA internal guidance to staff which states that “enforcement is used sparingly and it is particularly important that it is used in a disciplined way. Cases which are investigated by enforcement must be likely to ‘make a difference’”³⁶. Senior FSA staff have explained that this culture is a direct effect of the merging of the 11 precursor regulators into the FSA, and the need to standardise the approach to enforcement to bring different regulatory cultures to a similar and consistent approach.
- 114** We believe that there is a risk that the FSA’s regulatory culture, through the laudable aim of achieving a consistent regulatory approach, may have unintentionally lowered the profile of

³⁴ John Tiner evidence to the House of Lords Select Committee on Regulators 20 March 2007 <http://www.parliament.uk/documents/upload/correctedEv620070320.pdf> pg4

³⁵ John Tiner evidence to the House of Lords Select Committee on Regulators 20 March 2007, pg4

³⁶ FSA internal guidance document

enforcement options within the overall sanctioning strategy. This has the effect that some potential cases may not be referred to the Enforcement Division.

- 115** As a consequence, the demonstration effect may not be maximised. The value of a deterrent needs to be kept high to discourage gaming. Similarly, in order to reward compliant behaviour, the deterrence effect of a regulator needs to be strong. The key question for the FSA is ‘do businesses face an effective deterrent to inappropriate or illegal behaviour?’ The point is to achieve a demonstration effect, and this requires a balance. We believe that the balance is not in the right place at the moment, particularly with its current low-key emphasis on ‘naming and shaming’. We would like to see the FSA place a greater emphasis on ‘credible deterrence’.
- 116** The FSA is already well aware of these issues. It has placed emphasis on embedding links between the Enforcement Division and supervisors, both to raise the profile of enforcement tools and to allow the advice and guidance of experienced enforcers earlier in the process of developing a case.
- 117** In addition, as described above, the FSA as an organisation has a wide variety of tools available to encourage firms to improve their behaviour. However it is only a certain sub-set of these tools that are publicised widely. Some of the less-public sanctioning tools available to FSA supervisors³⁷ can have as much, if not more, of a punitive effect than its more public financial penalties. We believe that a key way that the FSA could increase the profile of sanctions – and hence its demonstration

effect – is by publicising more of the outcomes of its full range of sanctions. This might include disclosing publicly the results of thematic reviews and analysis of complaints about firms to a greater extent than at present.

- 118** We therefore consider that the FSA could make greater use of the ‘name and shame’ approach. For example, it could give greater publicity to its use of supervisory ‘private sanctions’ effects that we highlighted earlier – such as the costs of requiring a firm to undertake a past-business review³⁸ or to undertake a ‘Skilled Person’s Report’. The FSA is currently considering adopting a policy of greater public disclosure in a range of areas, as referenced earlier in the ‘Transparency’ section.
- The FSA is keen to do more on criminal sanctions and wants to increase its levels of fines**
- 119** The FSA is currently considering increasing the levels of fines it levies. It is undertaking an empirical and quantified analysis of how best to deter wrongdoing and encourage appropriate behaviour within firms. We would strongly encourage taking forward this approach and look forward to seeing higher levels of ‘demonstration effect’ deterrence from the FSA in future.
- 120** From conversations with FSA Enforcement staff, we understand that the FSA is considering increasing the levels of criminal sanctions that it takes, particularly in the area of insider dealing now that it considers that the Market Abuse regime has ‘bedded in’. The review team would encourage this move, in line with the principle of ‘credible deterrence’ discussed earlier.

³⁷ such as a Section 166 Review, or a requirement for a firm to undertake a past-business review

³⁸ Such as reviewing past sales of a product and ensuring that customers who purchased products from unsuitable recommendations receive appropriate redress.

Focus on Outcomes

Hampton principle

“Regulators should measure outcomes and not just outputs.”

Key findings

- **The FSA has clear outcome-focused objectives, but needs to do more to communicate them both internally and externally**
- **The FSA has a sophisticated set of metrics but needs to do more work to link them to the day-to-day activities of staff**
- **FSA staff have a clear sense of purpose and work effectively to their statutory objectives**

Background

121 To help the FSA measure and evaluate its performance, it has translated its four statutory objectives and principles of good regulation into three high-level goals:

- Helping retail consumers achieve a fair deal
- Promoting efficient, orderly and fair markets and
- Improving business capability and effectiveness).

Underneath these three high-level goals it has developed nine outcomes – which express in more detail the high-level outcomes that the FSA aims to achieve for consumers, markets and their own effectiveness.

122 Underneath the nine outcome indicators are 87 metrics that show whether these outcomes are being met. The outcomes are fixed and long-term, whereas the metrics are more flexible and subject to change. The FSA reports performance on these outcomes and metrics through its Outcomes Performance Report (OPR). The

OPR aims to provide a single repository of performance information about how well the FSA is meeting its statutory objectives.

123 The OPR contains a mix of long-term and short-term measures and seven data sources provide half the data for the metrics. Some of the outcomes are difficult to develop specific metrics for, and therefore proxy indicators have been developed (for example, for Outcome 5 – financial crime³⁹).

124 The OPR report is not currently on the FSA website, it is seen as an internal management tool for the Board. However, the FSA Board has decided that a summary of the OPR will be published on the website in the near future.

Review Findings

The FSA has clear outcome-focused objectives, but needs to do more to communicate them both internally or externally

125 The FSA has clear, outcome-focused objectives which relate to its overall aim. It has developed the OPR as a means of

³⁹ Firms and other stakeholders understand their respective responsibilities and mitigate risks relating to financial crime and arising from market conduct

assessing how it is performing against its three high-level regulatory outcomes. The OPR is very outcome focused. Measures include use of a 'quality of advice outcomes' survey and an investment consumer purchasing outcome survey.

- 126** Although intended primarily as an internal management tool, the FSA plans to publish performance against its objectives on its website. We would encourage the FSA to put as much information as possible on its performance in the public domain,
- 127** There is a wider question that the OPR does not currently address, and that is around succinct communication of FSA's performance against its objectives both externally and internally. We note earlier that the FSA does not appear to have a 'consolidated story of success' and we feel a large part of this may be due to the complexity of its remit.
- 128** The review team would echo the findings of the NAO Section 12 report which stated that "the Outcomes report also has great potential as a device for disseminating priorities and messages to FSA staff"⁴⁰. Over time, it could fulfil this role of communicating the FSA's achievements and objectives to its staff. The FSA has published the last two six-monthly reports on its internal website which FSA say has raised awareness of it amongst staff. To perform this function effectively, the OPR may need to be more streamlined.

The FSA has a sophisticated set of metrics but needs to do more work to link them to the day-to-day activities of staff

- 129** The FSA has put a lot of work into developing appropriate outcome measures in a complex area. It has simplified its approach considerably in the last few years, and now has an impressive and sophisticated internal Management Information system, which is clearly linked to the organisation's statutory objectives.
- 130** The FSA accepts that the challenge now is to link this reporting process more clearly to the work of FSA teams in order for it to drive behaviour/performance more effectively. The FSA is looking to include more targets in the OPR, rather than just relying on indicators. Targets exist in some parts already, for example on Outcome 7⁴¹.

FSA staff have a clear sense of purpose and work effectively to their statutory objectives

- 131** The review team were impressed with the quality of staff that they saw during the review, and the commitment demonstrated to working across organisational 'silos' to pursue the FSA's statutory objectives. There was evidence of good strategic direction and a clear understanding amongst staff of the purpose of the FSA and the outcomes being sought.

⁴⁰ The Financial Services Authority: a review under section 12 of the Financial Services and Markets Act 2000, National Audit Office, April 2007 pg 19

⁴¹ The FSA is professional, fair, efficient and easy to do business with

Appendix 1: Review team membership

Philip Cullum, Acting Chief Executive of the National Consumer Council. Philip is Acting Chief Executive of the National Consumer Council. He is also a member of the Government's Risk and Regulation Advisory Council and is the first chair of the Food Standards Agency's new Advisory Committee on Consumer Engagement.

Peter Horne, Director of Strategy, Framestore CFC. Peter Horne is Director of Strategy at Framestore CFC, on secondment from the Department for Business, Enterprise and Regulatory Reform (BERR). At the time of the review, he was Director of Regulatory Innovation, Better Regulation Executive. He has previously worked for the Cabinet Office, the NHS and Unilever.

Ed Humpherson, Assistant Auditor General, National Audit Office. Ed is responsible for the NAO's private finance and economic regulation work amongst other responsibilities.

Dr. George Paterson, CBE, Director, Scotland, Food Standards Agency. George is Director of the Food Standards Agency Scotland where he is responsible for the development and delivery of the Agency's programmes in Scotland.

Appendix 2: Conclusions of the Hampton and Macrory reviews

Hampton principles of inspection and enforcement

- Regulators, and the regulatory system as a whole, should use comprehensive risk assessment to concentrate resources on the areas that need them most
- No inspection should take place without a reason
- Regulators should provide authoritative, accessible advice easily and cheaply
- All regulations should be written so that they are easily understood, easily implemented, and easily enforced, and all interested parties should be consulted when they are being drafted
- Businesses should not have to give unnecessary information, nor give the same piece of information twice
- The few businesses that persistently break regulations should be identified quickly, and face proportionate and meaningful sanctions
- Regulators should recognise that a key element of their activity will be to allow, or even encourage, economic progress and only to intervene when there is a clear case for protection
- Regulators should be accountable for the efficiency and effectiveness of their activities, while remaining independent in the decisions they take
- Regulators should be of the right size and scope, and no new regulator should be created where an existing one can do the work
- When new policies are being developed, explicit consideration should be given to how they can be enforced using existing systems and data to minimise the administrative burden imposed

Source: Hampton Report, Box E2 page 7

Macrory's principles and characteristics of an appropriate sanctioning regime

A sanction should:

1. Aim to change the behaviour of the offender;
2. Aim to eliminate any financial gain or benefit from non-compliance;
3. Be responsive and consider what is appropriate for the particular offender and regulatory issue, which can include punishment and the public stigma that should be associated with a criminal conviction;
4. Be proportionate to the nature of the offence and the harm caused;
5. Aim to restore the harm caused by regulatory non-compliance, where appropriate; and
6. Aim to deter future non-compliance.

Regulators should:

1. Publish an enforcement policy;
2. Measure outcomes not just outputs;
3. Justify their choice of enforcement actions year on year to stakeholders, Ministers and Parliament;
4. Follow up enforcement actions where appropriate;
5. Enforce in a transparent manner;
6. Be transparent in the way in which they apply and determine administrative penalties; and
7. Avoid perverse incentives that might influence the choice of sanctioning response.

Source: Macrory Report, Box E1 page 10

Appendix 3: Review scope and methodology

The review looked at all aspects of the FSA's work with the exception of its role as the United Kingdom Listing Authority, its supervisory role of Recognised Bodies and its supervisory role of the Wholesale market.

Wholesale was excluded because in the limited time available for the review this sector was considered insufficiently representative of FSA supervision to be a priority. In particular this area includes significant numbers of non-UK firms; in these cases the FSA's approach is highly tailored depending on a number of factors, including their legal status (EEA or third country; subsidiary or branch) and the FSA's assessment of the home country regulator. The review also looked at FSA's high level strategies and plans.

Our methods included:

- interviews with a wide range of FSA staff including senior managers;
- interviews with other stakeholders including trade bodies in the financial services sector and business representative groups;
- focus groups of FSA supervisors and small businesses;
- observational visits including supervision and the Firm Contact Centre; and
- document review

The review process is described in *Hampton Implementation Reviews: Guidance for Review Teams*. It is not the same as a full value for money audit of economy, efficiency and effectiveness and the review team's conclusions are both evidence- and judgement-based. These judgements, however, have been made drawing on a range of evidence from different sources, including those described above. Judgements have not been based on evidence from a single source – the review team has sought to bring together evidence from a number of different businesses or organisations, and from FSA front-line staff, policy officials and senior managers.

The organisations that we spoke to included:

Association of British Insurers
Association of Independent Financial Advisors
Barclays
British Private Equity and Venture Capital
Association
Close Brothers Bank
Confederation of British Industry
Davis Blank Furniss
FSA Smaller Businesses Practitioner Panel
FSA Practitioner Panel
FSA Consumer Panel
Greater Manchester Chamber of Commerce
Impact Insurance Services
Legal and General Group plc
Lloyds TSB
Royal and Sun Alliance
Signature Group
Which?

Better Regulation Executive
Department for Business, Enterprise and Regulatory Reform
3rd Floor
1 Victoria Street
London SW1H 0ET

Website: www.berr.gov.uk/bre

Publication date: March 2008

URN: 08/735

© Crown copyright 2008

The text in this document may be reproduced free of charge in any format or media without requiring specific permission. This is subject to material not being used in a derogatory manner or in a misleading context. The source of the material must be acknowledged as Crown copyright and the title of the document must be included when being reproduced as part of another publication or service.