

A TOUGH ACT TO FOLLOW



FIRMS AND CONSUMERS ARE WAITING TO SEE HOW THE FSA BEARS UP TO ITS NEW POWERS IN IMPLEMENTING NEW LEGISLATION. **CAROL SERGEANT** OF THE FSA REVEALS DEVELOPMENTS SO FAR.

On 30 November the Financial Services and Markets Act (FSM Act) will come into force in the UK. This is a genuinely historic moment – in that sometimes overworked expression – with the Financial Services Authority (FSA) coming into its full powers as the single regulator of the UK's financial services industry, and at the same time the entire basis of financial regulatory law being recast on to a completely updated and integrated basis.

Other countries are taking the single regulator route as well, but none have completely re-engineered the whole legal basis of regulation at the same time. So we have gone from one of the more complex regulatory structures in the world with our alphabet soup of regulators and statutes to one of unique simplicity – one Act of Parliament, one regulator, one handbook of rules and guidance, one FSA contact point for each firm. This is what the industry and consumers have called for and what we and the government have delivered over what has been a tough four years but which has been marked by a unprecedentedly deep and thorough consultation process to ensure we have been taking full account of the views of our many stakeholders.

This has all been quite seismic in itself, but we have gone considerably further by taking the opportunity of this re-engineering to conduct a review of our approach to regulation. What are the most important current and future issues the FSA should be focusing on if we are to meet the objectives the government has set us as part of its overall socio-economic strategy?

The outcome of this review is a risk-based approach with a clear statement of the realistic aims and limits of regulation. Equally important, it recognises the proper responsibilities of consumers and of firms' own management, as well as the impossibility and undesirability of removing all risk and failure from the financial system. The new approach is set out in *A new regulator for the new millennium*, published in January 2000, and the follow-up, *Building the new regulator – Progress Report 1*, published in December 2000, both of which are available on our website: www.fsa.gov.uk.

The challenge is to identify, prioritise and address risks and opportunities that are relevant to our four statutory objectives

– to maintain market confidence, promote public understanding of the financial system, secure appropriate consumer protection and reduce financial crime. Risk in this rather specialised sense is not the same as commercial risks undertaken by financial firms and within financial markets. Our approach is designed to provide a strategic planning and prioritisation framework to answer the basic questions: what developments, events or issues pose significant risks or opportunities to achieving our objectives, which of these matter most and how can we best deploy our resources (and indirectly the industries' resources) to addressing them?

In tackling these questions we are required by the FSM Act to observe certain "principles of good regulation", including economy and efficiency in the use of our resources, the responsibility of senior management of firms and the need to be proportionate in regulatory responses. We are also required to facilitate innovation and avoid unnecessarily distorting or impeding competition. Innovation and competition considerations play a key role in our cost benefit analysis work. Our new approach is designed to ensure that we apply our resources to deliver the most effective regulatory action within these parameters.

In developing the framework, we first identified a set of high-level, generic risks to our objectives. For example, risks to the financial stability objective can generally be classified under a

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number of headings such as financial failure of firms; financial crime and market abuse; misconduct or mismanagement by firms; and market malfunction.

Risks to the consumer protection objective include these risks, and also inadequate understanding of products or services preventing informed decision making.

RISKS TO THE OBJECTIVES. It is these risks to the objectives which provide the common framework enabling us to assess risks and opportunities in a consistent way. Traditionally, regulators' efforts have focused on individual firms, but our framework recognises that risks to our objectives can also arise from worldwide economic trends, the introduction of new products, developments in social policy, changes in consumer behaviour, technology developments as well as from many other sources.

The first step in our normal planning cycle will be to develop a view on the relative importance of key external developments which could impact on the rest of the FSA's objectives. We will do this after informal discussions with experts in the various fields (including the Bank of England and the Treasury) as well as the FSA's consumer and practitioner panels.

The next task is assessment and prioritisation. Here we use the concept of probability to assess how likely a risk to our objectives is to crystallise. But this is not the only relevant measure. We must also answer the question of how important is it for us? It is this indicator of impact which helps us to prioritise in allocating our resources. Once we have assessed and prioritised the risks, the key issue is how to address them.

In the past, regulatory effort has been focused on the individual firm. But experience suggests that this may not always be the best solution. In particular, it has often resulted in regulators only reacting to events in firms and financial sectors when our powers under the FSM Act give us opportunities to be much more active and forward-looking in managing the risks to our objectives. This is why our new approach stresses the importance of selecting from the full range of regulatory tools available to us, not just those which act on individual firms. The key point is to decide what is the most effective way of addressing the risks – that is, our focus will be on outcomes and what works, while having due regard to the principles of good regulation.

REGULATORY TOOLKIT. The regulatory toolkit, as it is known, is broad. Tools can be focused on specific firms, for example, on-site visits or disciplinary actions, or on consumer and industry-wide issues, such as disclosure, industry training or consumer alerts. The activities can range from negotiating the new Basel Accord on Capital for banks to working with school authorities to incorporate financial literacy in the national curriculum. Education and consumer awareness have not up until now been used widely by regulators, but they will often be the most effective and efficient ways of meeting our objectives.

We are also introducing a more 'thematic' approach to regulation – where we examine and respond to issues which are not company specific but which may affect our ability to meet our objectives such as those arising from particular markets, sectors, products or the external environment.

To mitigate these risks, we will again select from our toolkit. In the past year we have examined themes as diverse as the implications of a low inflation environment, consumer protection beyond the point of sale, e-commerce and money laundering. In the coming year we will be looking at what an ageing population

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means for the FSA's objectives and harnessing market forces (to address regulatory issues). Details on all the themes can be found on our web site.

However, this does not mean we are doing away with company-based supervision. We have carried out a preliminary assessment of the 10,000 or so firms we currently regulate to identify the level of risk they pose to our objectives. That assessment will help inform our analysis and monitoring of each firm. Where firms pose substantial risks, through a combination of their impact on the FSA's objectives, and the likelihood of problems arising, we will monitor them more closely. Where the level of risk is lower our relationship will be more arm's length, although such firms will have to meet certain minimum standards, set out in the FSA's Handbook of Rules and Guidance, and submit regular reports to the FSA so we can monitor the business.

Under our new regime, all firms are allocated to one of four categories imaginatively described as A, B, C and D. At one end of the spectrum we will maintain close and continuous relationships with category A firms, while at the other our routine oversight of category D firms will be based mainly on remote monitoring, supported by sampling of particular lines of business, plus cross-sectoral thematic work. We intend to undertake a full assessment of all firms (other than those in the D category) using our new framework by the end of the second quarter of 2002. The results of this assessment will be communicated to firms.

To lead this work we have created a new Risk Assessment Division as part of our new operational structure, which came into effect in April. This will be the custodian of risk assessment methodology and its implementation in the FSA and its work will include:

- identification of current and future external risks;
- aggregation of risk across all areas of the FSA (including company specific risks);
- prioritising risks and advising the FSA Board on resource allocation to meet them;
- strategic planning functions of the FSA as a whole; and
- cost benefit analysis and review of regulatory effectiveness and efficiency.

We have begun to test the firm-focused part of the framework. In the first phase of the pilot exercise we applied the framework to a diverse group of 50 firms in a desk-based exercise. This experience has helped us to refine the framework further. As a second stage in the pilot exercise, 13 firms or financial groups are receiving a full assessment using the new framework. This includes

visits to firms by FSA staff. The results of these risk assessments will be communicated to the 13 firms concerned and we will be seeking feedback from them on the effectiveness and efficiency of the process.

Although we are a non-profit company limited by guarantee there are some comparisons that can be made between us and commercial financial services companies. We operate on the basis of risks and opportunities to our objectives, while companies' risk management also focuses on its stated or unstated objectives – if only that of surviving! In both cases we and firms have to make difficult judgements about the choices we make on the basis of the best market and other intelligence and then be accountable for our decisions and actions.

Firms are mainly accountable to their shareholders and the usual standard of measuring performance will be profits and the movement of their share price. Ours is a different sort of accountability with a number of stakeholders. In particular, the FSA is accountable in the public interest to Parliament through ministers, which is achieved by:

- a clear mandate for the FSA through our statutory objectives and general duties which provide both political accountability and legal accountability through the scope for judicial review;
- accountability through Treasury to Parliament; Treasury will have powers to commission and publish value for money audits of the FSA and to commission official inquiries into serious failure in the system of regulation;
- clear governance structures: the FSA must have regard to the principles of good corporate governance; the chairman and the Board are appointed by the Treasury, with a majority of non-executive directors; there is also a committee of non-executive Board members with clearly defined responsibilities, including ensuring the economic and efficient use of the FSA's resources and setting the pay of executive Board members;
- public reporting mechanisms: an annual report to the Treasury on how the FSA has carried out its functions and met its statutory objectives, which is laid before Parliament; and an annual public meeting to discuss its Annual Report – the second of these was held in July this year; and
- an independent review of the FSA's rules and decisions: our rules and practices will be subject to competition vetting by the director general of Fair Trading and the Competition Commission; the Financial Services and Markets Tribunal, run by the Chancellor's department, will consider enforcement and authorisation cases afresh where there is no agreement on the outcome.

One of the main reasons that companies give for choosing to base their business in the UK is that the regulatory system is seen as rigorous, flexible and cost-effective. Consumers need to be confident that they can make informed choices in a market that is innovative, dynamic and sound. Firms and consumers alike will be wanting to see how the FSA implements the new legislation.

The FSA believes that the new risk-based approach will deliver better more focused regulation and that it will enable the FSA to explain more clearly to its many stakeholders why it has chosen to focus on particular issues.

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