

# Agenda

Advancing economics in business

## FSA review: creating a common language for regulation

The UK National Audit Office recently conducted the first ever performance review of the Financial Services Authority. The FSA was one of the world's first 'unified' financial services regulators, taking over the role of 11 other bodies between 1997 and 2005. After a decade of growth and development, how effective is it as a regulator of the UK's financial services industry? Ed Humpherson, Kathy Hall and Peter Langham of the NAO discuss the findings of their report

The National Audit Office (NAO) was invited by HM Treasury under Section 12 of the Financial Services and Markets Act 2000<sup>1</sup> to examine the Financial Services Authority's (FSA) value for money and hold it to account on behalf of Parliament, the Treasury and the FSA's large and diverse stakeholder community.<sup>2</sup> We were delighted to be asked, but knew that a challenging task lay ahead, not least to gather and reflect stakeholder views which are wide-ranging, strongly felt and sometimes in conflict.

The Treasury provided terms of reference for the review that covered five areas (see Figure 1). The challenge for us was not only to provide a robust yet constructive review of the FSA's activity in these areas, but also to provide a picture of the FSA which is recognised by both

the organisation itself and its stakeholders, and which is relevant to the wider context in which the FSA operates.

### What did we find? Our overall picture of the FSA

Our clear impression of the FSA is of a regulator in a state of continuous development and improvement. In becoming a coherent organisation from 11 separate regimes, the FSA has created a common methodology and language for its regulation, which lead to a consistent approach across regulated sectors. Achieving this has made the FSA, in 2007, an organisation rich in process. It recognises that it now needs to move forward in two areas:

- becoming a more principles-based regulator; and
- focusing on the actual outcomes it achieves in line with its statutory objectives for financial services markets and consumers. The FSA's statutory objectives are: maintaining market confidence in the financial system; promoting public understanding of the financial system; securing the appropriate degree of protection for consumers; and reducing the extent to which regulated businesses can be used for financial crime.

The quality of the FSA staff and the calibre of their judgements will be critical in achieving these developments. The FSA has announced an additional investment of £50m over a three-year period to improve the organisation and the effectiveness of its staff—for

**Figure 1 Areas covered by the review**



example, by training and development and improved knowledge management.<sup>3</sup>

## Our detailed findings and recommendations

Our report sets out detailed findings and almost 20 recommendations under our five terms of reference areas.

### Performance management

The FSA has put in place good systems and processes to allocate its resources to higher-risk firms and manage its own performance. We particularly welcome the FSA's new Outcomes Performance Report, designed to measure the FSA's success in achieving outcomes for consumers, markets and its own performance.

The FSA can develop these systems in two key ways. First, it needs to enhance its cost information to give it a better grip on the costs of its activities—for individual projects, for supervising firms and, at the highest level, between authorisation, supervision and enforcement. Second, the FSA should look to streamline and fully integrate its Outcomes Performance Report as experience of using it grows.

### Working with other UK regulators

The FSA has strong and improving relationships with its main regulatory partners—the Office of Fair Trading (OFT), The Pensions Regulator and the Financial Reporting Council. The priority area is collaboration with the OFT, the UK's primary competition authority. The two organisations recently concluded parallel projects on the sale of payment protection insurance by financial institutions, the outcome of which shows effective joint working and provides a model for future interaction. To make the most of their relative areas of expertise, and to avoid duplication, the OFT and the FSA should seek out opportunities to work together wherever possible.

### Influencing and representation internationally

The FSA commits significant resources, including senior management, to influencing international developments. It is generally effective, both in the EU and globally, at engaging with others and influencing discussions. Stakeholders generally consider that the FSA does reasonably well in a complex environment, although some remain confused or frustrated by aspects of the FSA's aims or approach in Europe, including coordination with Treasury, the UK's principal negotiator on financial services. We therefore welcome the Treasury's decision to draw up a memorandum of understanding with the FSA that sets out clearly their respective roles on international influencing and representation. We consider, however, that the FSA

could sharpen up communication of its strategy and achievements to its stakeholders, without prejudicing its negotiations in Europe. At the international level, the FSA is highly respected for its thought leadership on regulatory approaches—for example, on risk-based regulation, and also on specific issues that affect the global financial markets such as credit derivatives.

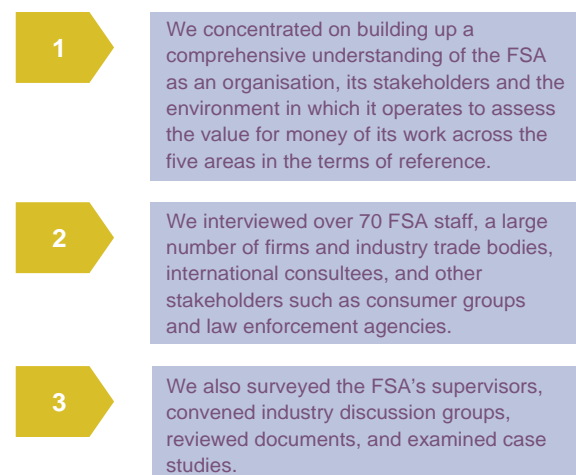
### Financial crime

The FSA's financial crime statutory objective has received less attention than others—indeed the FSA devotes less than 10% of its resources to this objective. It does not necessarily need to increase this allocation, but could use its current resources more effectively. We welcome the steps the FSA has already taken to achieve this, primarily the creation of a new Financial Crime Division. The new Division should prioritise reviewing the assessments it makes of firms and enhancing the financial crime skills and training of the FSA's supervision teams. The FSA's new approach on money laundering, developed through the Joint Money Laundering Steering Group, has been widely applauded by the financial services industry.

### Financial capability

We are largely positive about the FSA's financial capability programme. Its focus on improving outcomes, its consumer research and the projects it is now implementing, put the FSA at the leading edge internationally on addressing financial capability. It can build on this early success by assessing the costs of low levels of financial capability to society and to the market. It should also set measurable goals for improvements in consumer outcomes against which to measure success. Moving forward, financial capability issues need to be further embedded across the FSA's retail regulatory activity.

**Figure 2 How did we do the work?**



## Concluding remarks

In conclusion, despite some stakeholder concerns, the FSA is highly regarded by many in the UK financial services industry and abroad. We have highlighted some specific areas for improvement, particularly on cost information, impact measurement and both internal and external communication and collaboration. Our recommendations can help the FSA board and senior

executives continue to develop the FSA into a more principles-based and outcome-focused regulator. The FSA has responded positively to the report, issuing a comprehensive statement which sets out how it proposes to implement our recommendations.<sup>4</sup>

**Ed Humpherson, Kathy Hall  
and Peter Langham**

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<sup>1</sup> When passing the FSMA, Parliament did not appoint the NAO as the FSA's auditor, but the Act does make provision for a value-for-money review to be conducted by invitation of HM Treasury.

<sup>2</sup> NAO (2007), 'The Financial Services Authority: A Review under Section 12 of the Financial Services and Markets Act 2000', April.

<sup>3</sup> FSA Annual Report 2006/07.

<sup>4</sup> FSA (2007), 'Response to the National Audit Office's Economy, Efficiency and Effectiveness Review of the Financial Services Authority', statement, available at [http://www.fsa.gov.uk/pages/Library/Communication/Statements/2007/nao\\_review.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Statements/2007/nao_review.shtml).

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email [d\\_holt@oxera.com](mailto:d_holt@oxera.com)

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