Implementaton

THE VERY MODEL OF A MODERN REGULATOR?

Callum McCarthy looks back on two years at the helm of the Financial Services Authority, and describes the three strands that will shape its future work.

I have been at the Financial Services Authority (FSA) for two years now, though it seems, depending on the events of a particular day, like either the blink of an eye or a lifetime – an indication of the business of the FSA, and its very wide agenda.

Indeed the size of our responsibilities runs wider than any other financial regulator, in terms of both sectoral range – banking, insurance, securities, fund management, markets, retail finance and listing duties – and international reach. For example, of the 360 banks we supervise, more than two-thirds are incorporated outside the United Kingdom, and include the world headquarters of some of the biggest global banking operations.

We are responsible for international policies, like the new definition of capital requirements for banks and investment firms – now finally brought to conclusion by the Basel Committee and being translated for the European Union in the form of the Capital Requirements Directive. This may sound like an academic exercise until you recognize that banking crises typically result in a one-off cost to a country of about a fifth of its annual

GDP. We are also responsible for work within a European context on directives covering investment services, prospectuses, market abuse; for policies aimed at preventing financial crime; for work to reform the accounting and regulation of insurance; and for managing the new mortgage and general insurance responsibilities given to us, which brought an extra 14,000 firms within our scope.

I could go on, but won't. My point is that it is easy to see the FSA as the source of a constant stream of activities, and to miss the overall shape or central policy that connects them.

Let me set out the big picture. Cutting through all the individual initiatives, programmes and projects, there are three strands to our work. Firstly, to ensure there are efficient, orderly and fair markets; secondly, to help the retail customer get a fair deal; and thirdly, to improve our business capability and effectiveness – that is, to make the FSA easier to deal with. Let me deal with each in turn.

Orderly markets

Efficient, orderly and fair markets should be an objective on which everyone can agree. Efficiency is needed for the continuing competitiveness of Britain as the most international of all the world's capital market centres. Markets need to be orderly to work effectively – as disjunctions and disruptions impose large costs – and to be fair and clean, free from insider trading, manipulation, or favouring of one class of dealer or customer over others.

The most important pieces of work we have under this strand are:

- Continuing examination of softing[1] and bundling, to eliminate conflicts of interest and improve transparency. We expect the market itself to come up with solutions (as indeed it has on disclosure), and will resort to regulatory intervention only if a market solution is not produced. We have come forward with principles, but expect the implementation of these to lie with the senior management of the firms.
- New rules for insurance and reinsurance, where the accounting and regulatory framework has clearly been inadequate. For example, our principles and practice of financial management for with-profits business and our new rules for capital adequacy for life companies are reforms that had long been needed.
- For general insurance, we are setting all participants in the London market the challenge of working together to secure a market-driven solution that will achieve contract certainty. Again, we hope that the companies involved will deliver an appropriate solution, and will resort to direct regulation only if they do not.
- New rules for the capital adequacy of banks and investment firms, building on the work of the Basel Committee, via the Capital Requirements Directive.
- A raft of other European directives, where the FSA is legally bound to implement what has been agreed in Brussels – particularly the Markets in Financial Instruments Directive.

On top of these initiatives, we will continue our normal market monitoring and supervision. In our supervision work, we also intend to adopt a thematic approach that will focus on five areas. These are conflicts of interest, corporate governance, business continuity, stress testing and market abuse.

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In addition to these supervisory themes, we have the challenge of taking on our new responsibilities in the insurance sector, and of responding to – that is, anticipating and monitoring – developments such as the rise of hedge funds and credit risk derivatives.

Fair dealing

The second strand of our work is making sure the retail customer gets a fair deal. The retail market for financial products is complicated one. The product is often inherently complex – certainly for long-term, equity-linked instruments. Customers are often ill-equipped to make the decisions increasingly being asked of them, as the onus for provision shifts more and more from the state and from employers to the individual. And, of course, sales forces have too often been irresponsible. To make the retail financial services market work effectively, we need customers who are responsible for their decisions; clear information for them to base decisions on; and providers of services that sell those services responsibly.

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This involves a change from the present position, above all in establishing a greater degree of competence amongst customers – hence our emphasis on financial capability. In a country in which more than 20% of the adult population can neither use the Yellow Pages nor understand relatively simple percentages,[2] improving financial capability is a very long-term generational task that involves many players besides us – including both the industry and the government. But it is essential if we are to make the retail market work.

Within our retail market objective, there are a number of other projects aimed at helping achieve clearer information and responsible providers:

- We are placing priority on, and giving more resources to, activities aimed at preventing mis-selling, through our work monitoring financial promotions. We want firms to prepare promotional material that is clear, fair and not misleading, and will be easily understood by their customers.
- We will continue to implement Key Facts for other investment products, following their introduction for mortgages and general insurance. We will also conduct checks to ensure that firms are providing the disclosures in the right format and at the right time to consumers.
- This work forms part of our overarching theme of Treating Customers Fairly (TCF). Firms have a huge incentive to treat their customers fairly. It is *their* brand that is at stake, and many business gurus would argue that treating customers fairly – and so ensuring that they keep coming back to you – is what good marketing is all about. We are much more interested in encouraging good behaviour than in fining miscreants after the event, and we are working with the industry to spread best practices in this area.

Business made easy

The third strand of our work is simply to make the FSA easier to do business with, by improving our capability and effectiveness. There are many components to this:

- We are reviewing, in partnership with the Financial Services Practitioner Panel[3], the costs and benefits of regulation. In looking at this, we have given a commitment that, where we have discretion, we will intervene in markets only when there is a market failure and where regulatory intervention is likely to be cost-effective.
- We have halved the number of consultation papers that we issue, and we will continue to make them crisper and shorter.
- We have taken steps to make the Handbook more accessible. By tailoring its contents to only those rules that are relevant to them, we have reduced the size of the Handbook for mortgage and general insurance brokers by some 90%. We recently set out detailed ideas to further simplify and shorten the Handbook, and we will come forward with more proposals next year.
- We will develop clearer internal and external service standards, and publish detailed information on our performance against them. We are committed to providing faster turnaround times for our regular interactions with firms, consumers and other stakeholders. Currently, we meet or nearly meet 90% of our standards – something on which we plan to improve.
- We will aim to improve the standard and training of FSA staff. We have about a hundred people seconded either to or from the industry at any time and a strong and growing graduate training programme, which will help. Some 60% of the people we recruited last year joined us from the financial services industry, which will further add to the level of expertise and experience in the FSA.
- Finally, we will continue to develop ways of dealing with firms that reflect their size and the issues that exist. This is especially important following the expansion of our responsibilities to cover mortgage and general insurance regulation in the last year. More than 90% of the 26,000 firms we now regulate are regarded as small firms, and when developing policies we will consider the likely effects specifically on those firms.

That, then, is the big picture: three strands of work, each with many components. They provide groupings that make the FSA's multiple activities more comprehensible and more coherent, and highlight the many challenges which the financial services industry and the FSA face.

I have indicated our response to these challenges – all designed to see London continuing as an efficient market, operating to high standards, and the place of choice for international financial services companies.

I am confident that the industry will respond to these – and other – challenges with the same flexibility that it has always displayed, never more so than in the sometimes turbulent, always dynamic, two decades since Big Bang. □

Callum McCarthy is Chairman of the Financial Services Authority.

[1] The practice of using "soft" payments to investment managers from clients for investment research and other related services.

[2] See www.lifelonglearning.co.uk/mosergroup/ for the Moser Report into Financial Literacy, which includes this staggering research finding. Ed

[3] The Financial Services Practitioner Panel (FSSP) is a statutory body made up of industry practitioners. Under the Financial Services and Markets Act 2000, the FSA is required to consult the panel during the regulatory process, to ensure that the views and interests of regulated firms are heard.