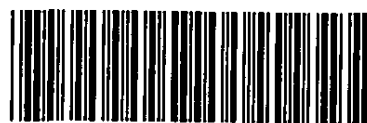


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## FSA Annual Report 2012/13

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## Executive Chairman's Introduction

*Introduction from Adair, Lord Turner, Executive Chairman of the FSA until 31 March 2013*

This is the last Annual Report of the Financial Services Authority (FSA). It covers the 12 months to March 31 2013. From April 1 the FSA's responsibilities were divided between its two successor bodies, the PRA and the FCA.

I took over as Chairman of the FSA on 20 September 2008. Stresses in the global financial system had been growing since the previous summer. Over the subsequent three weeks they intensified, producing the worst financial crisis for 70 years. The financial crisis revealed significant deficiencies in the prudential regulatory approach which the FSA, in common with other regulators and central banks across the world, had applied in the pre-crisis period. But the FSA had already recognised some of those deficiencies in the Internal Audit Report on Northern Rock, published six months before I arrived. And the organisation I joined was determined to recognise and publicly admit its mistakes, to learn from them and to put them right.

Over the subsequent four and a half years, the FSA radically reformed its approach to prudential supervision and was a global leader in the definition and implementation of new capital and liquidity standards. We also made major changes in our approach to conduct regulation, intervening earlier when issues first arose, and more effectively addressing long standing issues such as payment protection insurance (PPI) mis-selling. We built steadily over the years a more effective enforcement approach of credible deterrence. And the Markets Division continued to oversee the London wholesale market professionally and effectively.

The FSA's successor bodies will build on these achievements. They will be in a better position to do so because they are able to focus on the distinct challenges of prudential and conduct regulation and supervision. The sheer range of FSA responsibilities and activities described in this report illustrates the case for a new organisational approach which will enable that distinct focus. But delivering the effective demerger of the PRA and FCA has inevitably been a major challenge – requiring a myriad of decisions relating to personnel, process design, premises and IT support. On the FCA side it has also involved extensive preparation for major new regulatory responsibilities – in particular, the competition objective that the FCA was given on 1 April 2013, and the responsibility for consumer credit regulation which it will assume during 2014.

This year's Annual Report therefore begins with a section on the regulatory reform process. Organisational change, however desirable, is always potentially disruptive – it can too easily divert attention from business-as-usual challenges and risks. It is therefore greatly to the credit of the organisation that we delivered the structural change smoothly, while continuing to meet major external challenges.

Many of these challenges were foreseen in last year's Business Plan. These include

- Delivering financial stability (pages 12 to 22). This has entailed continued work, domestically and internationally, on the development and implementation of prudential policy, in the areas of shadow banking, CRD IV, Solvency II and the bank liquidity regime. It has also involved ongoing prudential supervision and stress testing of individual firms, and a continual focus on risks potentially arising from external developments, whether in the Eurozone or elsewhere. The extensive FSA input to the formulation and implementation of Financial Policy Committee decisions has also been crucial: this included important steps taken in summer 2012, at the FSA's initiative, to ensure that rising capital and liquidity requirements did not offset the potential economic benefits of the Bank of England's Funding for Lending Scheme.

- Delivering market confidence (pages 23 to 36) This has been achieved through supervisory initiatives such as market surveillance, market abuse and transaction reporting. It involved implementing key domestic policies such as those relating to listing rules, regulated covered bonds and client asset protection. We were also closely involved in influencing and implementing evolving European regulatory regimes such as MiFID and EMIR.
- Delivering consumer protection (pages 37 to 56) Here we developed our supervisory approach to enable more effective early intervention, and we continued implementing the Retail Distribution Review and started implementation of the Mortgage Market Review. Domestic-focused action has also involved the with profits review, the banning of referral fees, and ongoing oversight of the PPI redress procedures. Important international work has related to MiFID, UCITS and compensation and dispute resolution directives.
- Acting on financial crime (pages 57 to 60) This entailed requiring the regulated sector to improve its defences, increasing the intensity of our supervision, and working with our partners across Government and law enforcement, both in the UK and overseas.

Alongside these foreseen challenges, however, the organisation also had to respond to new developments that evolved after publication of the 2012/13 Business Plan. These included

- More extensive work on LIBOR than originally envisaged. The successful conclusion of various LIBOR-related enforcement cases during the year reflected work by Enforcement Division under way since 2009 – an illustration of the long lead times involved in complex cases. But the wider issues raised about the sustainability and effectiveness of the entire LIBOR-setting process led to the commissioning of the Wheatley Review and its recommendations for more robust supervision of contributing bank processes and control frameworks. Our enforcement findings also prompted questioning of what the FSA had known or ought to have known about LIBOR manipulation in the years 2007 to 2009. Our Internal Audit Report, published in March 2013, set out the facts clearly.
- Similarly, while the issue of interest rate swaps sold to small businesses was already under review in 2011/12, new evidence suggested that failings in sales processes were more widespread than had been initially apparent. We carried out significant work to define and secure firm agreement on appropriate review and redress procedures.
- And on the prudential side, the year ended with substantial and successful FSA activity to ensure that depositors of Cypriot banks in the UK were protected as best as possible from the potentially adverse effects of Cyprus's bank resolution process. For me it was striking that my first week as chairman in September 2008 involved a major focus on the problems of Iceland – a small island whose banking system had grown out of proportion to its national economy, and that my last two weeks were dominated by similar concerns.

My tenure at the FSA began amid the most profound financial crisis since the 1930's. That crisis, coming on top of long-standing conduct problems, such as the mis-selling of PPI, has eroded trust in the financial services industry. The PRA and the FPC will need to be continually vigilant in the face of the continuing consequences of the financial crisis. The FCA must seek, alongside the industry itself, to ensure that better conduct enables trust to be restored.

As they do so, the successor bodies will build on the FSA's achievements and reforms over the last several years. These achievements were made possible by the hard work and commitment of our staff. I leave the FSA confident that they will continue to rise to the challenges in the successor organisations.

## **Section one: Regulatory reform**

### **Operating 'twin peaks' and the move towards legal cutover (LCO)**

On 1 April 2012, the Financial Services Authority (FSA) was restructured internally into a 'twin peaks' model in preparation for legal cutover, and on 1 April 2013 the FSA ceased to exist and was replaced with the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Resources were re-aligned and processes changed in both prudential business unit (PBU) and conduct business unit (CBU) supervision to implement the distinct approaches and to allow the PBU and CBU to take forward their own supervisory priorities in an independent but co-ordinated manner. The FSA implemented the process changes required for the authorisation of firms regulated by the FCA and PRA from December 2012.

This 'twin peaks' structure enabled the FSA to test, improve and implement the design of the PRA and FCA supervision operating models in preparation for legal cutover. It also allowed PBU and CBU staff to focus more explicitly on their respective prudential and conduct supervision priorities, and to test the coordination arrangements needed when the PRA and FCA came into effect. During the year the FSA adapted and improved some aspects of the new arrangements to support an orderly and progressive approach to the new regulatory system. The adaptations ranged from building and developing relationships and key contacts between the PBU and CBU to support the model for cooperation and coordination to clarifying and developing the new supervision processes and framework, including joint panels and the risk tolerance for each organisation.

The FSA also communicated with firms to explain what the changes would mean for them, including, where relevant, the details of their key supervisory contacts. Operating under Internal Twin Peaks allowed firms to become familiar with some of the differences involved in dealing with two independent regulators and to consider changes they may have to make to the way in which they manage their regulatory relationships. Acting on feedback from firms, the CBU and PBU sought to ensure that the regulatory regime is proportionate and co-ordinated, and clear on what is expected from firms.

### **Other preparatory work**

The FSA also undertook further preparatory work ahead of the change to a new regulatory structure. The Financial Services Act 2012 received Royal Assent in December 2012 and confirmed the date of legal cutover as 1 April 2013, broadly in line with expectations at the beginning of the planning period. Preparations were completed on time and within budget, ensuring a smooth operational transition. A range of Memoranda of Understanding (MoU) were drafted and agreed between the new regulators and other relevant parties.

To achieve this the FSA worked closely with the Bank of England (BoE) to ensure a smooth transition of people, data and assets to the BoE and PRA, with physical moves of over 1,000 staff taking place between January and March 2013. Twenty-four technology systems were copied from the FSA to the PRA for ongoing use beyond legal cutover. Four systems requiring data sharing and continued usage by the FCA and PRA were identified and a link was set up between the two organisations to allow access in a cost-effective manner.

Extensive work was also undertaken to prepare for the FCA, including building a new website and intranet, rebranding buildings and systems, and changing processes to comply with the new legislation.

Staff also received training in the changed regulatory processes.

## **Cooperation and coordination**

During 2012/13, the FSA worked closely with the BoE to develop and finalise the statutory MoU including the FCA/PRA MoU, With-Profits MoU, and BoE/PRA/FCA MoU on Recognised Bodies Supporting documentation, including operating manuals and service level agreements were also developed. These documents are designed to underpin the relationship between the regulators. The documents take into account lessons from Internal Twin Peaks and, for published MoU, feedback from external stakeholders.

### **Authorisation of dual-regulated firms**

Dual-regulated firms that apply for regulatory authorisation are subject to a conduct assessment by the FCA and a prudential assessment by the PRA at the regulatory gateway. CBU and PBU colleagues worked closely to design a process that minimises the burden on the applicant so their application is managed through a single administrative process rather than separate applications to each regulatory authority. This included developing fully updated process manuals for both conduct and prudential staff for all Authorisations processes to prepare for consistent dual regulation. The processes were tested in a live environment from December 2012 when Authorisations Internal Twin Peaks was implemented. This meant coordinating the approach to assessing the conduct and prudential aspects of each application.

## **Approved Persons – development of FCA/PRA regime**

The Approved Persons regime is an important regulatory tool, employed to ensure not only that the right individuals are appointed at the approval stage but that the regulator remains satisfied that they are fulfilling their responsibilities throughout their life as approved persons.

In October 2008, the FSA implemented an enhanced process for approval of Significant Influence Function (SIF) holders within higher impact firms. The main effect of this focus was to introduce a more robust approach to the fitness and propriety of individuals put forward for such positions. The aim was to have a process that conducts high quality assessments of those individuals who are genuinely in a position to put FSA objectives at risk. This includes the chairman, the senior independent director, the chair of the risk and audit committee, the CEO, the finance director and the chief risk officer, with others judged on a firm-specific basis. Such assessments typically involved formal interviews conducted by senior members of the regulator and the FSA's Senior Advisers. An internal review of this process was undertaken in April 2012 to ensure that decisions to interview a candidate are robustly risk-focused and in line with PBU/CBU objectives. This resulted in a re-focusing of efforts and a reduction in the overall number of SIF interviews.

In designing the Approved Persons regime for the new regulatory regime, the focus was on delivering the changes that are required to implement the Financial Services Act 2012. Both the PRA and FCA will continue to keep the regime under review and in particular to take into account any recommendations resulting from the Parliamentary Commission on Banking Standards.

### **Improving the Authorisations processes**

In February 2013 the FSA also completed the first stage of a work programme to improve all Authorisations processes, involving stripping out inefficiencies and automating low-value activities, allowing more time to be spent on higher risk, complex cases.

### **Barriers to entry report**

On 25 March 2013 the FSA and the BoE jointly published a report containing the findings of their review of the requirements for firms entering or expanding in the banking sector. The review was requested in the Treasury's White Paper response to the reports by the Office of Fair Trading (OFT) and the Independent Commission on Banking (ICB) in June 2012 on competition and barriers to entry in the banking sector. The purpose of the review was to ensure requirements are proportionate and not unnecessarily burdensome for new and potential bank entrants, as well as banks looking to expand their activities.

The review covered the capital and liquidity prudential requirements and conduct rules for new banks as well as the authorisation process itself. It involved both internal and external consultations, including firms, overseas regulators and industry advisors and consultants, individually and via industry roundtables. The conclusions of the review have resulted in some significant and far-reaching changes that will have a positive impact for new bank applicants. They include:

- a clearer and more efficient authorisation process,
- two routes to authorisation, depending on the firm's circumstances,
- one of the authorisations routes includes a reduction in the initial information requested in the application, followed by bespoke additional information requests,
- no automatic liquidity premium because a bank is new, and
- significant capital reductions at authorisation for new banks judged to be resolvable with no systemic impact, with up to five years to build up to the level of their peers.

The Conduct Standards remained unchanged as they were not considered to pose barriers to entry to new entrants. This also ensured that consumers continue to be protected while encouraging new entrants to the banking sector.

These changes will be carried forward by the PRA and FCA as appropriate.

## **Building the PRA**

### **The PRA's objectives**

As part of the preparations for the PRA, the FSA worked with the BoE to establish how the PRA would meet its new objectives. The Financial Services Act 2012 gives the PRA two statutory objectives:

- To promote the safety and soundness of all the firms it supervises, this involves firms having resilience against failure and avoiding harm resulting from disruption to the continuity of financial services provision. In promoting safety and soundness, the PRA will be required to focus primarily on the harm that firms can cause to the stability of the UK financial system.
- And, specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are, or may become, policyholders.

The PRA will advance its objectives through regulation, by setting standards or policies that it expects firms to meet, and supervision, by assessing the risks that firms pose to the PRA's objectives in the context of these policies and taking actions, where necessary, to reduce them. The PRA's approach to regulation and supervision will have three defining characteristics:

- a judgement-based approach – in determining whether financial firms are safe and sound and whether insurers provide appropriate protection for policyholders,
- a forward-looking approach, assessing firms not just against current risks, but also against those that could plausibly arise in the future, and
- a focused approach – concentrating on those issues and firms that pose the greatest risk to the stability of the UK financial system and to policyholders

In October 2012, the FSA and the BoE published two documents setting out the PRA's approach to banking and insurance supervision. These documents were re-issued at legal cutover by the PRA, having taken into account subsequent legislative developments and feedback received.

The FSA undertook extensive work within the PBU to put in place the policies, structures and processes to enable the PRA to deliver on its new objectives. The PRA's new governance arrangements were also established, including the creation of the PRA Board, which held its first meeting on 7 March 2013.

### **Becoming part of the Bank of England**

Practical preparations to create the PRA and enable it to operate as part of the BoE were also completed in time for legal cutover. The BoE's central services functions, including Communications, Finance, HR, Internal Audit, IT and Legal, were scaled up to provide support for the PRA. Systems and processes were adapted as necessary to deliver services to PRA staff, including IT and data supporting supervisory processes. Joint teams from the BoE and PBU were established and a joint governance structure was put in place in the form of project boards reporting to the Transition Programme Board, chaired by Andrew Bailey.

The PRA is based at 20 Moorgate, London. Moorgate was selected following a review by the BoE's Court of Directors, which considered the costs and benefits of locating the PRA in the City of London and the importance of the physical proximity of the PRA to the BoE. This proximity will facilitate the integration of the PRA to the BoE's policy and operational functions, and ensure the PRA can draw on the BoE's central services in an efficient and effective manner.

In early 2013, staff moved to both the PRA building on Moorgate and the BoE's Threadneedle Street office from the FSA offices in Canary Wharf. Over a three month period, more than 1,000 people were moved with minimal disruption to business-as-usual at either the FSA or the BoE. As part of this process, transferring staff received induction and training into BoE policies, processes and systems to support their integration into the BoE. Interim solutions were developed while part of the FSA operated from the BoE's premises at the start of the year.

### **ICB proposals**

Over the last year, the Government developed its proposals for financial services reform based on the recommendations of the ICB. In February 2013, the Government introduced the Financial Services (Banking Reform) Bill into Parliament. This followed pre-legislative scrutiny of the draft Bill by the Parliamentary Commission on Banking Standards. The Bill, as introduced into Parliament:

- introduces ring-fencing of core retail activities from investment banking activities within large banking groups,
- requires the PRA to exercise its general functions so far as reasonably possible in a way that seeks to minimise disruption to the continuity of the provision of core financial services in the UK,
- specifies the areas for future PRA rule-making to ensure, as far as reasonably practicable, the integrity of the ring-fence, and
- enables the Treasury to specify loss-absorbency requirements as envisaged by the ICB.

As well as assisting the Treasury throughout the policy development process, the FSA also provided both written and oral evidence to the Parliamentary Commission on Banking Standards to assist them.



in their scrutiny of the draft Financial Services (Banking Reform) Bill. In line with the White Paper response to the ICB proposals the FSA produced a review, jointly with the BoE, into barriers to entry, expansion and exit in retail banking. Further details on our work on barriers to entry can be found on page 7.

The FSA also supported the Treasury in its European negotiations of the relevant directives to ensure that the ICB's other recommendations can be fulfilled, such as higher capital buffers and a bail-in resolution power.

#### **Northern Irish Credit Unions**

Regulatory responsibility for all Northern Ireland Credit Unions was transferred to the FSA as planned on 31 March 2012. Since transfer, a proportionate approach was applied to their supervision and the FSA proactively engaged with the largest credit unions.

Regarding the Northern Irish Credit Unions' annual returns for the year-end September 2012, the level of Single Customer View compliance was found to be high, owing to their good quality records and organisational abilities.

### **Building the FCA**

As part of the preparations for the FCA consideration was given to how the FCA would meet its new objectives. The Financial Services Act 2012 gives the FCA three statutory objectives:

- To secure an appropriate degree of protection for consumers.
- To protect and enhance the integrity of the UK financial system.
- To promote effective competition in the interests of consumers.

The FCA will advance its objectives through regulation, by setting standards or policies that it expects firms to meet, by promoting competition where it will deliver innovation and choice to consumers, and through supervision by assessing the risks that firms pose to the FCA's objectives in the context of these policies and taking actions, where necessary, to reduce them. The FCA's approach to regulation will have three defining characteristics:

- a forward-looking approach – to identify and tackle problems that risk harming consumers or the integrity of markets earlier, including their underlying causes;
- a judgement based approach – focused on achieving the right outcomes rather than just following a process, and
- a pre-emptive approach – to intervene earlier and take meaningful action when we see problems and before they cause consumer detriment or damage to market integrity.

#### **Judgement led approach to Supervision**

During the year the FSA continued to develop a more forward-looking, pre-emptive approach to conduct supervision. This means identifying problems at firms and risks to consumers before they occur and result in actual detriment. In order to do this, it is necessary to make judgements about some key aspects of how a firm is run and the risks this poses as a result. In particular, there is a focus on a firm's business model and forward looking strategy, and the way its culture affects the way the firm operates and treats its customers. Regulatory intervention occurs if there are unacceptable risks to the fair treatment of customers or to the integrity of the market.

## **The FCA's competition objective**

The Financial Services Act 2012 gives the FCA an objective to promote effective competition in the interests of consumers, as well as continuing the FSA's duty to do so when exercising general functions (making rules, guidance, codes and internal procedures). Together the objective and duty provide the FCA with a strong, pro-competition mandate. In 2012/13 the FSA developed the FCA's future approach and thinking so that it was ready to advance its competition objective and competition duty from inception.

This work also included developing skills and expertise in competition in preparation for the new organisation. A new Director for the Policy, Risk and Research Division was recruited, with significant previous experience of competition regulation, to lead the development of the FCA's new competition department. The recruitment process for key personnel for the new Competition Department, including a Director of Competition, was also started.

## **Competition – Market studies**

On 19 December 2012, the FSA announced that it had commenced a study to assess how competition works in the markets for General Insurance add-on products. The study looks at whether there are common features of those markets that weaken competition, drive recurring poor consumer outcomes and allow firms to make persistently high profits. Add-on insurance cover is often sold in conjunction with selling another, more valuable product, such as an insurance contract or financial service. Following a scoping exercise, consumer and firm research was carried out in February and March. The first phase of the project, the problem identification and assessment stage, is due to be completed by the end of the third quarter of 2013.

### **FSA and competition**

While the FCA has an objective to promote effective competition, the FSA was required to have regard to competition when making rules, codes, general guidance and general policy in pursuit of its regulatory objectives (consumer protection, market confidence, financial stability and reducing financial crime). Specifically, the FSA was required to have regard to the need to minimise adverse effects on competition, and the desirability of facilitating competition.

Aside from pursuing and enforcing against non-compliance with rules, the FSA mostly addressed market failures such as information problems and negative externalities.

### **Relationship with the OFT**

The FSA cooperated with the OFT on the basis of the 2009 MoU. Through participation in workshops, regular meetings between the CEOs, working-level meetings between the relevant teams and other communications, the two organisations informed each other's thinking on a variety of areas.

## **Consumer credit**

The Government confirmed its proposal to transfer responsibility for consumer credit regulation from the OFT to the FCA in April 2014. In preparation for this transfer the FSA worked with consumer bodies, the industry and Government to develop proposals for effective regulation that helps the market work well and seeks to ensure the fair treatment of consumers. The FSA published proposals for the new regime in March 2013. This was the first consultation and provided an outline of the proposed regime including a high level approach to authorisation, conduct standards, supervision, reporting and other areas.

The programme of work to deliver the regime transfer within relatively tight timelines includes a number of operational challenges including

- delivering clear and effective communications to around 40,000 firms affected by the transfer, their trade associations, consumer groups and other key stakeholders,
- ensuring relevant system build and readiness to facilitate interim permission registrations, full authorisations and associated supervisory activities,
- the migration of OFT staff, business readiness to operate the regime, and
- delivering the various activities within the broader headcount constraints described in the FCA's 2013/14 Business Plan

#### **Consumer Credit Programme - Authorisations**

The transfer of Consumer Credit regulation may require an estimated 38,000 firms to receive interim permission by 1 April 2014 and 32,500 firms to apply for authorisation or extending their existing permissions between September 2014 and April 2016

The FSA developed processes, target operating models, business requirements and people/cost models to underpin and prepare for both the interim permission phase and the authorisation phase of the programme, from both a regulatory transaction and contact perspective. It also began engaging with the OFT regarding its existing processes, people and systems. The first Consultation Paper was issued on 7 March 2013, which provided an outline of the regime, including high-level approach to authorisation, conduct standards, supervision, reporting and other areas. The consultation also outlines a future approach to risk appetite and categorisation of consumer credit firms, and the approach to interim permission and authorisation.

Interim permission is designed to ensure that OFT-licensed firms that wish to can continue carrying on their credit activities after 1 April 2014, by confirming key details of their OFT licence online and paying a one-off fee. Interim permission will expire by April 2016, so firms must have applied for authorisation before this date to continue regulated consumer credit activities.

For the authorisation phase, the FSA established two defined groups within the population of consumer credit firms in line with a proportionate, risk-based approach. It identified where firms carrying on certain consumer credit activities are less likely to cause harm to consumers – these firms will have different, less intrusive authorisation requirements and will therefore be subject to a 'limited permission' regime.

#### **Process review for mutuals registration and Authorisations**

The FSA (and the FCA in the future) performed the role of registrar for all mutual societies: Building Societies, Credit Unions, Friendly Societies and Industrial & Provident Societies. As registrar the regulator is responsible for registering these legal entities and ensuring any changes to their details on the Registry are not contrary to the appropriate legislation or the society's rules. The regulator also receives the societies' annual accounts and returns, making this and other information available to the public upon request.

The FSA reviewed how the delivery of functions to mutual societies and the public could be improved. This included considering how to improve the functionality of internal case management systems and the external facing mutuals public register. The review also looked at how registrar functions are carried out. Some of the high volume low valued-added processes will be automated, to create more capacity for the mutual areas where value can be added. The interaction between the registrar, societies and the public was also reviewed, to make contact with the regulator easier and quicker.

## Section two: Delivering financial stability

### Introduction

The 2012/13 *Business Plan* highlighted that the FSA would continue to focus on forward looking assessments of risks and that early, proactive interventions should reduce the risks to the stability of the system

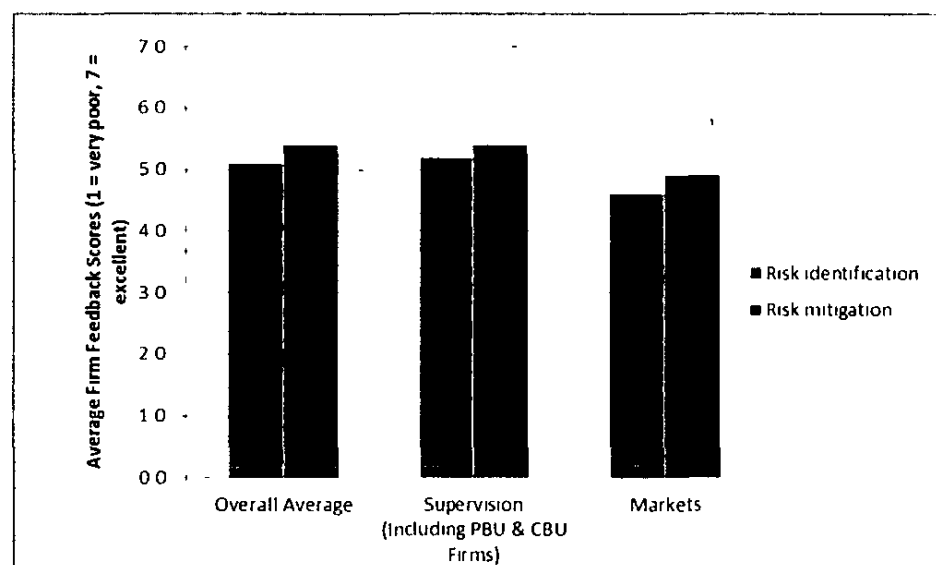
This chapter shows how it delivered on the 2012/13 *Business Plan* aims, set out as

- supervisory initiatives, including developing the supervisory approach, stress testing, assessing operational resilience of firms,
- Domestic policy initiatives, including guidance on internal audit and the establishment of the FPC,
- international policy initiatives, including the Capital Requirements Directive (CRD IV) and Solvency II, work on the liquidity regime for banks and systemically important financial institution (SIFIs)

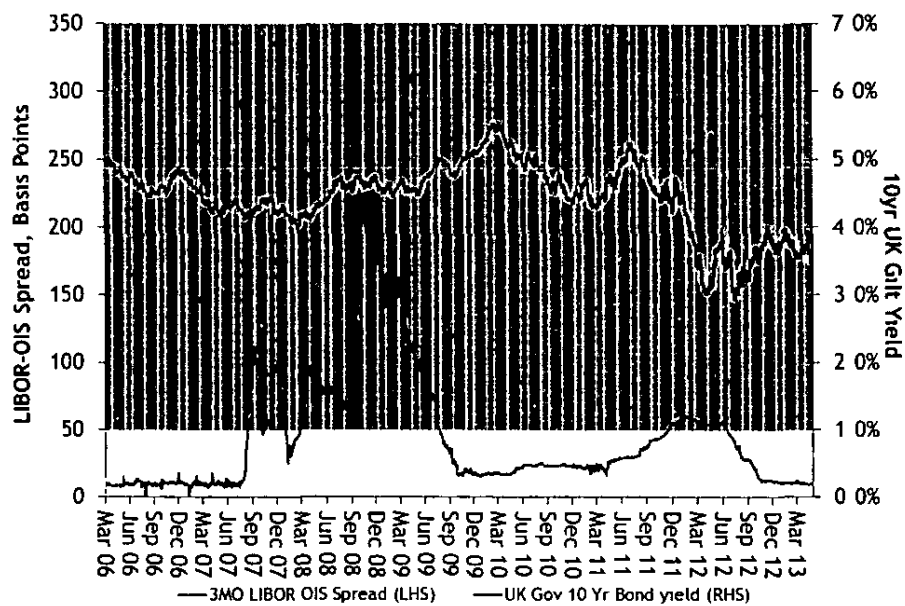
### Key metrics:

The principal metrics we use to assess our supervisory effectiveness in relation to the financial stability objective and to gauge financial stability include the following

**Chart 1: Firm feedback on the quality of FSA supervisory risk assessments**



**Chart 2: Cost of credit**

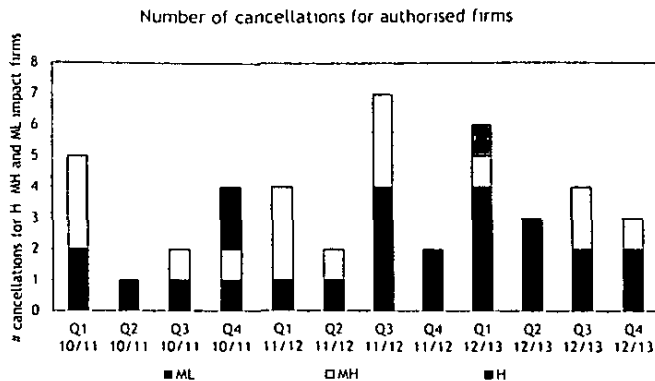


Source: Bloomberg

The (3month) Libor-OIS spread is a measure of perceived counterparty risk in short-term inter-bank funding markets. It can be used as a gauge of banks' reluctance to lend, higher levels indicate less willingness to lend. The spread has been on a downward trend since the beginning of 2012 which suggests lenders are willing to lend.

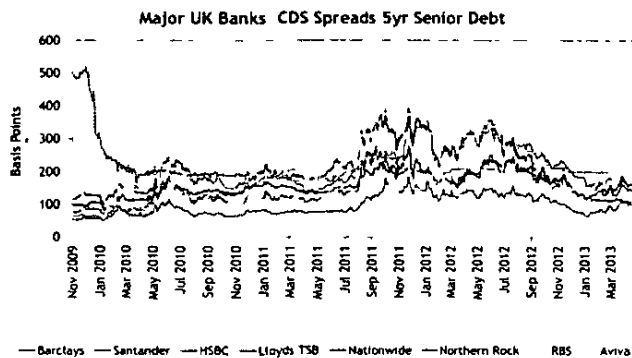
The 10-year gilt yield represents the cost of long-term funding for the UK Government. Weak growth and a prolonged period of low interest rates, the UK's status as a safe-haven country (despite recent downgrades by rating agencies), and the impact of QE, have all led to increased demand for gilts whose yields have remained at historic lows. Low gilt yields increase pension fund liabilities and lead to lower annuities for pensioners.

**Chart 3. Number of cancellations by firm/sector**



The total number of cancellations for all Authorised and EEA-Authorised firms for the period 2012/13 (Q2 2012 to Q1 2013), including where there was no impact score, was 1779 firms. Within these figures, the data for firms with a high (H), medium high (MH) and medium low (ML) IRM (Interim Risk Manager) impact score is shown in the chart above. This was an 8% decrease in the number of cancellations in the previous year (2011/12). There has been a decrease in the numbers over the last few years, the number of cancellations in 2010/11 was 2,080, in 2009/10 2,573 firms cancelled and in 2008/9 2,792 firms cancelled.

**Chart 4. Major UK banks – CDS Spreads – five year Senior Debt**



Banks' CDS spreads are an indication of market perceptions of credit risk. Spreads have mainly been on a steady decline since peaking around Q3 2011, reflecting banks' efforts to improve their capital positions and greater confidence in the stability of the financial system. However, while CDS spreads have narrowed more recently, they spiked at the end of March following statements by the FPC that major UK banks and building societies will need to raise a total of £25 billion in extra capital by the end of 2013.

## Supervision

### Developing a prudential supervisory approach

#### *Banks*

In Banking Supervision supervisory tools were improved to help supervisors make sound judgements about risk prioritisation and actions that should be taken by firms. This focused on deepening the assessment of banks' business models and their resilience under a range of conditions, as well as assessing their risk management, controls and governance structures.

For banks and building societies for which the FSA was the home regulator, the supervisory strategy focused on building on experience to deepen and enhance understanding and assessments of

- business model sustainability,
- capital and liquidity stress-testing, and
- governance and risk management effectiveness

The FSA worked with firms to strengthen their management of capital and liquidity and readiness for implementing the new international capital and liquidity standards.

Work also continued on recovery and resolution plans for banks and building societies, including through supervisory colleges and crisis management groups.

For banks where the FSA was a host, rather than home supervisor, the strategy targeted improving understanding of the risks inherent in firms' business models which in turn helped to focus the analysis of recovery and resolution plans. This informed the FSA's engagement with the relevant overseas home regulators through supervisory colleges and crisis management groups. The FSA also undertook a number of actions to limit the impact on the UK financial system where firms' UK operations have been endangered by risks to the viability of the overseas group. This included working with the BoE's Special Resolution Unit to undertake contingency planning for a number of firms where we considered the risk of failing to have been particularly high.

#### **Co-op – Verde**

The UK Government's support of the Lloyds Banking Group (LBG) in 2009 was subject to the European Commission State Aid clearance, which committed LBG to sell or divest part of its retail banking business (known as Verde). LBG identified Lloyds TSB Scotland plc, a regulated entity, for the purpose of creating and divesting Verde.

The FSA assessed and monitored the risks to successful execution of the Verde project, including its IT readiness and system build, and its readiness to divest the business either through sale or an IPO. The FSA had first set out its requirements that the Co-operative Banking Group (Co-op Bank) would have to meet to gain approval of its bid for Verde in 2011. Co-op Bank then became the preferred bidder on 14 December 2011, but the requirements remained in place. During the year, the FSA focused accordingly on Co-op Bank's capacity to take on the Verde business. This included assessment and monitoring of Co-op Bank's readiness to incorporate Verde, including its risk management, controls and governance, and capital and liquidity requirements.

The Co-op Bank's bid for Verde did not progress to the stage where the FSA needed to give approval. The FSA was in regular dialogue with the Treasury on these matters.

### *Insurers*

As with banks, supervisory tools continued to be strengthened during the year, ensuring that prudential supervisors made appropriate judgements in prioritising risk and actions that firms need to take

In Insurance Supervision, the roll out of the more intensive approach to supervision of the major insurance groups and Business Model Analysis (BMA) for other firms was mostly completed. This work enhanced the capability of supervisors to assess the risks to sustainability of firms' business models and financial positions, drawing on business as well as regulatory data

Solvency II continued to be an important component of the FSA's supervisory work during the year, including assessing the progress firms have made towards implementing the standards anticipated in the new Directive. Further details on the FSA's work on Solvency II can be found on pages 21-22

In 2012, further work was carried out on developing the supervisory approach, leading up to the publication of the *PRA Approach to Insurance Supervision* document in October 2012. The Insurance Division also designed working level guidelines to ensure this approach can be properly implemented and is sufficiently resourced. This included determining the level and type of supervision that different firms will receive based on their assessed impact category. One important priority in preparing for the new regulatory structure was to consider how to clearly divide responsibilities between the PRA and FCA over the supervision of with-profits. This has now been agreed and codified into the MoU between the two new authorities

### *Firms that are neither deposit takers nor insurers*

The FSA also continued to develop its wider prudential supervisory approach to firms beyond banks and insurers based on the principle that firms should be allowed to fail. Supervisory focus for these future FCA-regulated firms would therefore fall on minimising the impact of the firm's failure on consumers and market participants by ensuring that customers' assets and money were protected and that the firm could be run down without adversely affecting consumers or markets

The wider prudential approach to these firms continued to ensure that their minimum prudential requirements were met. For the more prudentially significant firms, these prudential requirements remained based on a supervisory review of the capital and liquidity risks posed to that firm, whereas for the less prudentially significant firms they remained based on the minimum requirements specified in the FSA Handbook

This wider prudential approach to firms that are neither deposit takers nor insurers will continue now the FCA is responsible for their prudential supervision, however proactive prudential supervision will be limited to a relatively small number of 'prudentially significant' firms

Whether a firm was deemed to be 'prudentially significant' was determined through an assessment of the impact that the disorderly failure of that firm could cause in terms of market disruption and consumer impact. The assessment took into account factors reflecting the consequences of failure such as the size and nature of a firm's business, its importance to the market, and its holding of client money/assets

### **Using Business Model Analysis (BMA)**

BMA became a key part of the judgement-based supervisory approach



## *Banks*

The FSA made substantial progress on integrating BMA into the overall supervisory approach, tailoring the scope of work to reflect the impact and circumstances of the broad range of firms that the FSA supervised

For the highest impact firms where the FSA was the home supervisor, there was a rolling programme of conducting detailed BMA at business unit and group level to assist with assessing the main threats to viability and sustainability, as well as prioritising the overall supervisory work programme

For the highest impact firms where the FSA was a host supervisor, a similar approach was piloted but a number of changes were made to reflect

- the interconnection between the UK operations of a firm and those of the overseas parent,
- the limited ability to undertake a detailed assessment of a group that is headquartered outside the UK, and
- the reliance on overseas regulators to provide information on the overall stability of such groups

There was also joint work with some overseas regulators to assess the business model risks inherent in a number of firms where the UK presence represents a significant proportion of the group's operations. This helped to focus discussions in regulatory colleges and led to detailed follow-up work by the FSA and the home regulator, including recovery and resolution planning

With regard to non-systemic UK banks and building societies a proportionate level of BMA was undertaken, using analysis to identify the key issues in each firm, make judgements on viability and influence the development of supervisory strategies. For a large number of lower impact firms where the FSA was the host supervisor, an approach to assess business models by reference to peer groups of broadly similar firms was rolled out

## *Insurers*

BMA was extended to all insurance firms. This was accompanied by detailed guidance and a central team to support supervisors for the more complex cases. Given the wide variety of firms supervised in the insurance sector, an analytical approach proportionate to the complexity of the insurer's business model and potential impact of its activities on our regulatory objectives was adopted. The approach emphasises the assessment of the design and execution of a business model, as well as the mechanism for generating profit, cash and acceptable returns to capital.

Firms were subject to BMA as part of their overall programme of supervisory work and each assessment delivered a judgement on a firm's viability and sustainability. Where the risks identified from a BMA assessment were of sufficient priority, they were addressed through the supervisory strategy for the firm.

## **Stress-testing in banking**

Our analytics capabilities were substantially improved to help inform supervisory judgements. Some of the core credit stress-testing methodologies were re-engineered and enhanced to gain a more robust and forward-looking insight into the most material vulnerabilities in credit portfolios. The Analytics & Risk Technology (ART) platform was also completed. This enables concurrent stress tests across firms and scenarios for certain credit portfolios and speeds up the process of testing firm-wide capital adequacy under stress.

### **Using ART**

The Firm Data Submission Framework for supervisory stress test data was underway with seven major UK banks in 2012/13. The FSA worked individually with each of these firms to establish a mapping between their internal data definitions and that of the FSA's, to understand data provenance and flows and tailor the sourcing of data accordingly, and to agree internal reconciliations before submission. The outcome of this will be quarterly submissions for all of these firms under the new regulatory regime. The PRA will then run analytics on these quarterly submissions to inform forward-looking supervisory judgement empirically.

Several pilots were performed successfully using the ART platform to stress test different banks' credit portfolios, in parallel with the existing stress-testing process. These highlighted substantial improvements in efficiency. Following these tests the ART platform went live, and the first set of concurrent multi-firm, multi-scenario stress tests for certain credit portfolios took place in Q1 2013.

### **Stress-testing in insurers**

In December 2012, the FSA launched an updated, standardised stress-testing exercise covering large life insurance firms and groups, based on insurers' 2012 year-end financial positions. This exercise covered the ability of large life insurance firms to meet their regulatory capital requirements following ten market stress scenarios of progressive severity. The FSA also asked firms to assess the impact of stress events on their liquidity and cash flow.

Results are expected in summer 2013 and will provide valuable information on the financial resilience of larger life insurers. The FSA also worked with the BoE to benefit from their expertise in this area.

### **Resolution and recovery plans (RRPs)**

As part of our firm-specific prudential oversight, the FSA focused on ensuring that banks have effective RRPs. The FSA developed its RRP approach and reviewed the RRP plans of both small and medium banking institutions as well as the larger global banking institutions to reduce the impact of any potential firm failure. The FSA reviewed and challenged the effectiveness of the plans in place, to build more robust and actionable RRPs.

### **Operational resilience and the Market Wide Exercise**

The FSA conducted intensive reviews of resilience arrangements at major financial organisations and findings were discussed with them, to improve the understanding of their ability and that of the sector as a whole to withstand a major operational disruption. Observations of general interest were shared with the sector throughout.

An important aspect of follow up to the Market Wide Exercise was to ensure that the sector was prepared for disruption during the Olympic Games. This included improving alternate working plans and communications, widening understanding of payments systems and participation in an industry-wide stress test in May 2012.

Work continued to improve the understanding of the potential impact of large scale cyber-attacks, in particular, discussions with the sector were held regarding a follow-up cyber-exercise later in 2013 to validate improvements to response structure and process. The technology and cyber-resilience practices of 30 major financial institutions were compared to provide participants with peer comparison. Firms received summary reports in February and March 2013. This and the other work streams assisted our contribution to the Finance Sector Resilience Plan.

### **Directors of failed banks**

The FSA Board Report into the failure of Royal Bank of Scotland (RBS) raised a number of questions about how executives and boards of banks should be incentivised to place greater weight on avoiding downside risks. The FSA worked closely with the Treasury in exploring a number of options in this area. This led to the Treasury's consultation paper in July 2012 on '*Sanctions for the directors of failed banks*'<sup>1</sup>. This discussed the introduction of criminal sanctions for serious misconduct in the management of a bank, and proposed introducing legislation of a 'rebuttable presumption' that a director of a failed bank is not suitable to hold another position as a senior executive.

### **Domestic policy initiatives**

#### **Financial Policy Committee (FPC)**

The FPC, which gained its statutory footing on 1 April 2013, is an independent committee of the BoE and an important part of the regulatory reform in the UK. During 2012/13 the interim FPC continued its work to identify, monitor and publicise risks to the stability of the financial system and advised action to reduce and mitigate these risks. The FSA briefed the Committee regularly on supervisory issues. The FSA also supported its preparatory work in advance of the creation of the permanent FPC, including developing the macroprudential toolkit and publishing a draft policy statement, in January 2013, on how the FPC will use these tools.

The FSA responded to a number of recommendations made by the FPC on banks' disclosure, balance sheet resilience, liquidity buffers and capital position. The BoE's Financial Stability Report is published every six months and describes the progress made against these recommendations.

#### **Liquidity regime**

The FSA made it clear to firms that their liquid asset buffer can be drawn down in the event of liquidity stress and that they will be given reasonable time to rebuild their buffers subsequently. We also adapted our micro-prudential regime to recognise the additional insurance provided by the BoE through its Extended Collateral Term Repo facility and the Discount Window Facility (DWF). The FSA announced that for those banks engaged in the DWF, it would permit part of the pre-positioned collateral to be included in the banks' liquidity asset buffer. Consistent with these announcements, the FSA also consulted on the removal of the automatic transition path in the Simplified ILAS regime buffer requirement for certain less complex banks and building societies.

The FSA also engaged internationally on the issue of liquidity. Further details of international work can be found on page 20.

#### **Capital regime**

In September 2012, the FSA clarified changes to its capital regime intended to support lending to the real economy. This makes allowances for the increase in Pillar 1 capital requirements as a result of new lending to European households and non-financial companies by reducing Pillar 2 capital planning buffer requirements. The precise amount of this offset is determined in discussions with banks on their capital adequacy and forward-looking capital plans.

#### **Internal audit**

In the 2012/13 *Business Plan* the FSA stated that it wished to promote more effective internal audit functions, which FSA supervisors could rely on as part of robust corporate governance at major firms.

<sup>1</sup> [http://www.hm-treasury.gov.uk/d/consult\\_sanctions\\_directors\\_banks.pdf](http://www.hm-treasury.gov.uk/d/consult_sanctions_directors_banks.pdf)

It concluded that developing a Code of Practice was best undertaken in conjunction with the appropriate professional body, and in March 2012 the FSA approached the Chartered Institute of Internal Auditors, UK (the CIIA) to explore whether they would be interested in developing such a code. The CIIA established the Institute of Internal Auditors Committee for Effective Internal Audit in Financial Services (Committee) in September 2012 to oversee the development of the Code. The FSA were observers on the Committee and in February 2013 welcomed the publication of its consultation paper. It is expected that the final Code will be published mid-2013. To raise awareness of the FSA's interest in this subject, it also engaged directly with the heads of internal audit functions and chairs of audit committees of major UK banks and insurance firms.

## **International policy initiatives**

### **Banks**

#### *CRD IV*

The FSA continued its close engagement with the formulation of EU legislation on the prudential regulation of credit institutions and investment firms, known as CRD IV. This legislation is intended to implement Basel III in the EU and to provide for a single rulebook for European prudential regulation. The FSA supported UK negotiating parties through technical advice and analysis of the proposals, with the aim of ensuring the final legislative framework provides a sound and proportionate basis for supervising banks, building societies and investment firms. The ability to tackle systemic risks, ensuring thorough implementation of Basel III, and providing for a judgement-based approach to supervision were among the FSA's key priorities.

The FSA also continued to prepare for implementation on the basis of the best information available, and encouraged firms to do the same, while recognising that the delay to the European timetable meant that implementation would be later than the planned 1 January 2013. The content of CRD IV was finally agreed at European level in March 2013. Once it is formally adopted and signed into law, it is expected that it will take effect from 1 January 2014 (unless delays in translation and final publication mean it is published after 1 July 2013 in which case it will not take effect until 1 July 2014). The preparation undertaken will nevertheless ensure that there is capacity to move as quickly as possible to implement the necessary supervisory systems and changes and to be able to consult on all rule changes before the final legislation enters into force. Transitional periods and phasing in of various parts of the new requirements will run through to 1 January 2019.

#### *Liquidity*

In addition to its domestic work on liquidity, the FSA actively engaged in international work-streams to develop and introduce internationally agreed liquidity standards.

The FSA participated in international efforts at both the Basel Committee on Banking Supervision (BCBS) and at the EU level to establish a common liquidity regime. In the BCBS, the discussions concluded with the Governors and Heads of Supervision agreeing in January 2013 the Liquidity Coverage Ratio (LCR) and liquidity risk monitoring tools standards. The FSA also began work on the transition to the new regime.

At EU level, the FSA contributed to the discussions on liquidity in the CRD IV legislative package on liquidity reporting and on enabling the implementation of the LCR in the EU. Specifically we fully engaged in the European Banking Authority's (EBA) working groups on a number of different initiatives including assessing the impact of the LCR, designing the reporting templates, and developing the binding technical standards. The FSA also continued to facilitate the bi-annual rounds of BCBS and EBA's data monitoring exercise as well as the EBA's voluntary LCR monitoring exercise, which involved collecting and analysing data from participating firms.

## *SIFIs*

During the past year the FSA engaged closely with the relevant international work-streams being led by the Financial Stability Board (FSB), BCBS, International Association of Insurance Supervisors (IAIS) and International Organisation of Securities Commissions (IOSCO) directed at identifying systemic firms and developing internationally agreed policy measures for such firms

In November 2012, the FSB, drawing on the BCBS methodology, published a list of 28 institutions judged to be global systemically-important banks (G-SIBs). This list included four UK firms: HSBC, Barclays, RBS and Standard Chartered. Firms designated G-SIBs will be required to hold (phased in from 2016) additional capital in the form of an equity surcharge. The UK is also a host jurisdiction to other G-SIBs and potentially a number of other firms of systemic significance.

### **Shadow banking**

A key lesson from the crisis is that bank-like risks (credit extension associated with leverage and maturity mismatches) can be replicated by capital markets and other non-bank entities. The FSA attached importance to the international work to agree a common framework for monitoring and developing policy responses to such shadow banking activity, recognising that much non-bank credit intermediation does play a positive role.

Internationally, the FSA's Chairman, Adair Turner, led a major FSB project in this area, which published a number of important recommendations in November 2012. Given the capacity of shadow banking activity to evolve in the light of changing incentives (including those created by increasing bank capital standards), monitoring work and international collaboration will be an on-going activity requiring continued vigilance under the new regulatory framework.

## **Insurers**

### *Solvency II*

Due to the uncertainty surrounding the implementation date of Solvency II the FSA announced a revised planning horizon of 31 December 2015. The FSA also set out its intention to allow firms to use their Solvency II work to meet, as far as possible, the current requirements under the Individual Capital Adequacy Standards (ICAS). The extended planning horizon, led the FSA to begin re-planning ICAS reviews including for many firms in the internal model approval process (IMAP). In developing this approach, referred to as ICAS+, the FSA benefited from industry technical input via expert groups that we convened in late 2012 and set out in further detail in January 2013.

### *On-going policy negotiations*

During the year the FSA's engagement with the Treasury, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) continued. This has included negotiations on the Omnibus II Directive, along with Level 2 and Level 3 of the Solvency II Directive.

Discussions between the European Commission, European Parliament and European Council ('trialogues') began in the second half of 2012 on the Omnibus II and Level 1 negotiations to agree three substantive areas of policy, including the long-term guarantees package. Agreement was not reached at triologue and EIOPA was asked to undertake an assessment of the long-term guarantees package, which began in January 2013. The FSA invited UK firms to participate in the exercise.

The Level 2 drafting continued and the FSA maintained its representation on the relevant EIOPA committees and sub-committees that advise the Commission. The FSA advised the Treasury on prudential issues to ensure they have sight of risks in the Level 1 and draft Level 2 text. It also provided input to the EIOPA committees and working groups in the drafting of the Level 3 guidelines.

### *Engagement with industry*

Throughout 2012/13, representatives for the FSA spoke at industry events, on a range of topics, to give both internal model firms and standard formula firms information to prepare them for implementation. The FSA's engagement included setting out its thinking on how it will monitor the on-going appropriateness of internal models after approval using 'early warning indicators' as well as holding a number of industry briefings.

### *Consultation on Solvency II*

The FSA consulted on Solvency II rules in Consultation Papers CP 11/22, CP11/23 and CP12/13 based on Level 1 text. It issued a Feedback Statement FS12/2 in response to CP11/23, which included changes to Permitted Links rules. The FSA planned to issue a Policy Statement on Solvency II in January 2013, on both CP11/22 and CP 12/13, together with the final rules of the conduct elements of CP 11/23, to meet a June 2013 transposition date. Delays in the European process to finalise the Omnibus II Directive led to the decision to delay publication.

### *Plans for implementation*

Where policy is stable the FSA completed the relevant design and build of the processes required for the implementation of Solvency II. As the Directive articles summarising the internal model process have been deemed stable and require a significant amount of activity from firms and the regulator ahead of Solvency II implementation, this work was the focus of both the FSA and the insurance industry during this period.

In March 2013 EIOPA launched a public consultation on guidelines to prepare for Solvency II. These were intended to support both national supervisors and firms in their preparation for the Solvency II requirements at implementation.

### *Reporting requirements*

The FSA's engagement with EIOPA, at a working group level, continued throughout the year and it was represented at a number of the decision making and reporting committees. In July 2012, the FSA published a statement to confirm that, for quantitative reporting under CRD IV and Solvency II, it (or future bodies) intended to collect quantitative regulatory data using the Extensible Business Reporting Language (XBRL) standards and formats.

With the creation of the PRA, further consideration is being given as to what national specific reporting requirements are required.

### **Solvency II training**

The FSA continued to train its staff on the Solvency II Directive and on-going policy developments, including the ICAS+ approach, to ensure they were equipped with the specific knowledge and skills to complete their Solvency II work.

### *Solvency II – IMAP*

From April 2012 the FSA received submissions from internal model firms that were in its pre-application process, to achieve the implementation date of 1 January 2014. The FSA gave individual firm feedback through the course of 2012 and it also shared its high-level findings from IMAP review and assessment work on the Solvency II pages of the FSA website to inform and support other firms ahead of their own submissions.

## Section three: Delivering market confidence

### Introduction

One of the FSA's statutory objectives was to maintain confidence in the UK's financial system. The *2012/13 Business Plan* highlighted that the aim was to deliver efficient, clean, orderly and fair markets that remain attractive and sustainable, both in the UK and internationally.

High quality, transparent and open markets remain vital for the UK's position as a leading international financial centre.

This chapter sets out how the FSA delivered on the *2012/13 Business Plan* aims, set out as

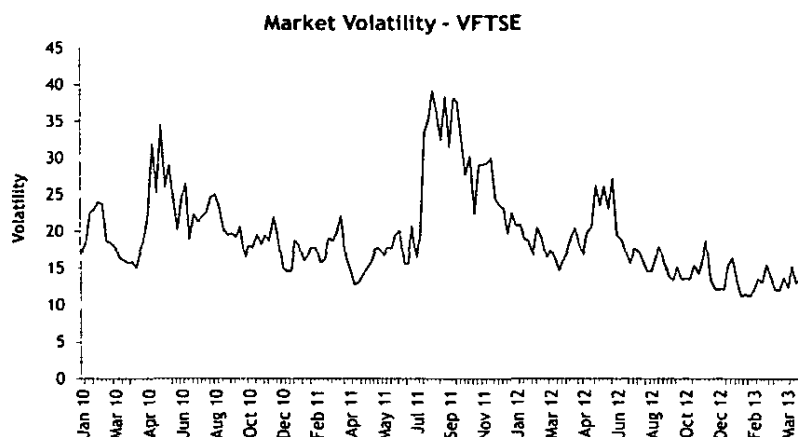
- Supervisory initiatives including market surveillance and market abuse and transaction reporting
- Domestic policy initiatives, including work on our listing rules, regulated covered bonds and client asset work (CASS)
- International policy initiatives, including Markets in Financial Instruments Directive (MiFID) and European Market Infrastructure Regulation (EMIR)

The FSA's work in response to the London Inter-Bank Offered Rate (LIBOR) also formed an important part of its work on market confidence in 2012/13.

### Key metrics

The FSA used a number of key metrics to measure its success against its market confidence objective, including

**Chart 1: Market volatility**



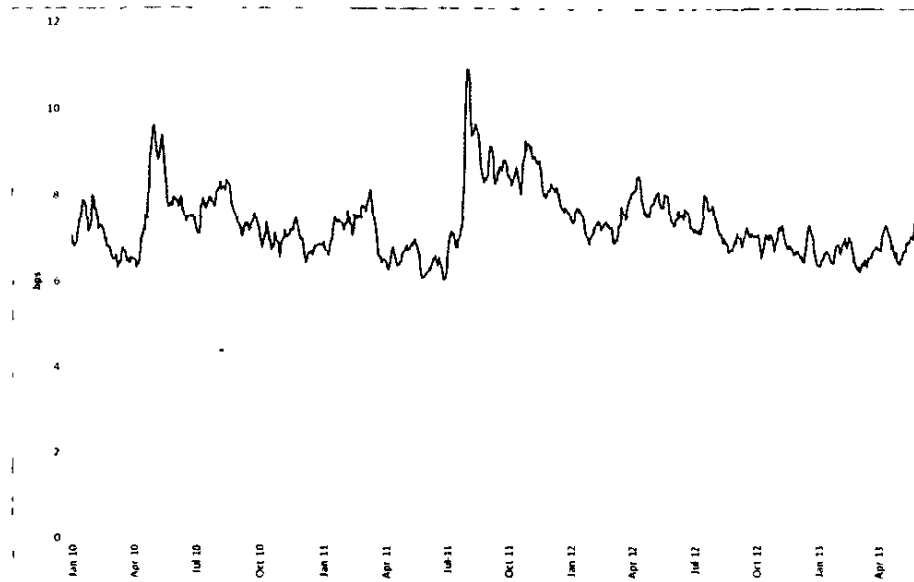
Source: Bloomberg

Equity market volatility has fallen to 13%, from 16% in December, despite continued weakness in the UK's economic outlook and on-going political uncertainty in Italy and recent events in Cyprus highlighting that issues in the Euro area periphery remain unresolved.

While central bank intervention has in part triggered a broad rally in financial markets, the returns on UK equities are unimpressive internationally when adjusting for inflation (and dollar terms). The low returns are reflective of the UK's weak economic prospects and are likely to discourage capital investment in the UK, inhibiting future growth. The VFTSE is the market's expectation of 30-day share

volatility expressed through FTSE 100 options prices. The higher the figure, the more volatile the stocks. A VFTSE index below 20 has historically been associated with periods of market stability.

**Chart 2 Bid-offer spread of FTSE 100 securities on the London Stock Exchange (5-day moving average)**



Source: Liquidmetrix

The spread is determined by the difference in the buy and sell price for FTSE 100 stocks. Generally, a smaller bid-offer spread indicates more efficient pricing and greater liquidity of the FTSE 100. The average bid-offer has stabilised towards 7 basis points throughout 2012 and into 2013, in line with the general improvement in global financial markets.

## Supervisory initiatives

### Market cleanliness

As part of our market monitoring activity, we analyse the scale of share price movements in the two days ahead of regulatory takeover announcements and identify movements that are abnormal compared to a stock's normal movement. We publish the statistics annually and remain the only regulator that regularly publishes market cleanliness statistics.

However, it is important to note that the level of such abnormal pre-announcement price movements (APPMs) does not provide a precise measure of the level of suspected insider dealing.

Many factors, other than insider trading, could cause an abnormal price movement ahead of a takeover announcement, for example, financial analysts or the media correctly assessing which companies are likely takeover targets or non-abusive trades that just happen to fall before an announcement. It is not possible to determine which of these factors are behind each abnormal price movement and therefore whether any insider dealing might have taken place.

After remaining stable for the four years to 2009, the level of APPMs declined to 21.2% in 2010, 19.8% in 2011 and to 14.9% in 2012. This is the lowest level since 2003. The fall took place in a year of weak takeover activity and against a backdrop of the FSA's continuing focus on market abuse and enforcement activity in this area.



## **LIBOR and the Wheatley Review**

Following a lengthy investigation the FSA concluded its case against Barclays for misconduct in relation to LIBOR. Shortly after publishing the FSA's findings, the UK Government commissioned Martin Wheatley to conduct an independent review of the production of the LIBOR in July 2012. The FSA provided support to the Review.

Following publication of the Wheatley Review the FSA worked to implement a regulatory regime for benchmarks, which initially will only extend to LIBOR. Under this regime, the FCA will directly supervise contributing banks' processes and control frameworks for submitting to LIBOR. The regime also requires the firms that administer LIBOR to have effective governance arrangements, as well as procedures for the monitoring and surveillance of submissions.

The regulatory regime for LIBOR came into effect on 2 April 2013.

### **Record fines for LIBOR misconduct**

This year the FSA took enforcement action against three firms for misconduct relating to LIBOR and other benchmarks. Barclays Bank plc was fined £59.5m in June 2012, UBS AG was fined £160m in December 2012 and RBS plc was fined £87.5m in February 2013. These are the largest penalties the FSA imposed. They breached Principle 5 of the Principles for Businesses by failing to observe proper standards of market conduct by making inappropriate submissions, as well as Principle 3 by failing to have adequate systems and controls around their submission setting processes. Barclays also breached Principle 2 by failing to conduct its business with due skill, care and diligence when considering issues raised internally in relation to its LIBOR submissions. The cases highlighted a range of misconduct. This differed from bank to bank, but included:

- making submissions that took into account requests made by derivatives traders at both the bank and other banks,
- taking into account the impact of LIBOR on the profitability of transactions in money market trading books when making such submissions,
- colluding with inter-dealer brokers and other banks in seeking to influence other banks' JPY LIBOR submissions, including making corrupt payments to reward brokers for their efforts,
- 'lowballing' submissions to avoid negative media comment,
- combining the responsibility for making LIBOR and EURIBOR submissions with that of derivative trading and other failures to manage the inherent conflicts of interest arising from benchmark setting and trading in instruments related to those benchmarks,
- the compliance function failing to respond appropriately to internal concerns raised regarding LIBOR submissions, and
- providing an attestation to the FSA about the adequacy of its LIBOR submissions-related systems and controls, even though at that time they were inadequate.

Investigations into benchmark-related misconduct continue under the new regulatory regime.

### *Approved Persons changes*

A key recommendation of the Wheatley review of LIBOR was specifying LIBOR activities as regulated activities, bringing LIBOR activities within the scope of statutory regulation. In December 2012 the FSA published its proposals for the regulation and supervision of benchmarks such as LIBOR. As of 1

April 2013, providing information to, and the administering of, specified benchmarks became regulated activities under FSMA

As part of these proposals, to assist the enhanced accountability and ensure compliance with its rules, the FSA extended the Approved Persons regime to create two new Significant Influence controlled Functions one for the oversight of submission processes within panel banks and one to oversee the governance arrangements at benchmark administrators. As a result those individuals in management roles in relation to the new LIBOR-regulated activities will have to become FCA approved persons

### **Supervising Multilateral Trading Facility (MTF) operators**

In 2012/13 the FSA began centralising its supervision of around 50 MTF operators alongside other trading venues to ensure that it supervised them to a consistent standard to the regulated markets they compete with, taking into account their markets. The FSA engaged with MTF operators to understand their business models and the specifics of the markets in which they operate to inform the design of a supervisory framework. The framework is designed to ensure that where an MTF has a significant market impact, or impact on the FCA's statutory objectives, it will have a closer supervisory relationship with the FCA. Further, it will incorporate a peer group approach based on asset class to seek a level playing field within individual markets to facilitate competition. The FSA concluded the design phase of the framework and wrote to all UK MTF operators in March 2013 to inform them of the future approach

### **Market abuse and insider dealing**

The FSA had a successful year that has seen the culmination of many years' work in several criminal and non-criminal investigations. It continued to take civil and criminal action to support its credible deterrence agenda and keep markets clear and fair. It also published a number of market abuse enforcement outcomes and saw the conclusions of a record number of insider dealing trials this year.

#### *More convictions and longer sentences*

Over the last 12 months the FSA conducted four criminal trials, prosecuting more individuals for insider dealing this year than any other. This included James Sanders and Richard Joseph, who both received four year sentences in separate cases for insider dealing, which are the highest sentences imposed in FSA insider dealing cases to date.

#### *Increasing complexity of cases*

The cases we bring are increasing in complexity, and this year the FSA successfully prosecuted its most complex case to date, Operation Saturn, securing the convictions of an insider dealing ring trading multiple stocks between 2006 and 2008.

#### *Increase in guilty pleas*

In 2012/13 the FSA saw an increase in the number of defendants charged with insider dealing who pled guilty, with five individuals pleading guilty in the period. One of these, Thomas Ammann, was sentenced to two years and eight months' imprisonment for two counts of insider dealing and two counts of encouraging insider dealing. Mr Ammann had used inside information to encourage two others to deal. The FSA's most recent plea was from Paul Milsom, a senior equities trader, who was sentenced to two years' imprisonment for disclosing inside information between 2008 and 2010.

#### *Increase in convictions of approved persons*

This year saw increasing numbers of FSA approved persons being convicted. This is as a result of targeting individuals within the industry in our market abuse investigations. Examples of approved

persons convicted this year are James Sanders and James Swallow, who were sentenced to four years and ten months in custody respectively after pleading guilty to insider dealing. Both Sanders and Swallow had been FSA-authorised directors at Blue Index, a specialist Contract for Difference (CFD) brokerage.

#### *Recovery of proceeds*

Proceedings are on-going to recover the proceeds of crime from those prosecuted in the last year, but the FSA has secured over £2.4m since 2009.

#### *Non-criminal outcomes*

Where criminal prosecutions have not been appropriate the FSA also continued to bring non-criminal action for regulatory market abuse, including imposing fines of £1.58m on three individuals, and four prohibitions for market abuse and market manipulation. The Upper Tribunal also issued a judgement upholding an FSA decision to impose an £8m penalty on a company formerly known as Swift Trade Inc. for repeated market manipulation.

#### **Operation Saturn**

This was the longest and most complex prosecution brought by the FSA to date. Following a four and half month trial, six defendants were convicted of insider dealing in July 2012 and all received prison sentences ranging between 18 months and 3.5 years. The defendants, Ali Mustafa, Pardip Saini, Paresh Shah, Neten Shah, Bijal Shah and Truptesh Patel, obtained confidential and price sensitive information from investment banks concerning proposed or forthcoming takeover bids. They then used a large number of accounts to place spread bets before announcements knowing that when the information became public knowledge, the price would rise. The defendants were convicted of making a combined profit of £732,045 trading six stocks. Proceedings are ongoing to confiscate the defendants' proceeds. It was a sophisticated and complex scheme in which the defendants took careful steps to conceal activity such as the use of un-registered mobile phones and email drop-boxes.

To uncover and investigate the criminal actions, the FSA obtained and reviewed over 200,000 lines of trading in 130 accounts and 375,000 lines of telephone call records. Digital forensic technology played a critical part in establishing the passage of data between the defendants. Over 300 witness statements were adduced at the trial.

This case demonstrated the FSA's determination to tackle serious insider dealing and its capability to investigate complex rings and methods of committing this crime and to bring the perpetrators to justice.

#### **Market surveillance**

The FSA acquired software that enhanced its technological intelligence based detection of market risks and abuse. This work will enhance proactive detection of market abuse under the new regulatory regime.

The FSA also established the Investment Bank Surveillance Forum (IBSF) in Q3 2012. It invited the largest 12 investment banks by transaction reporting volumes in the UK to attend to discuss surveillance and market fragmentation as well as an opportunity for sharing best industry practice and encouraging competition. Both the IBSF and the Surveillance Practitioners Group, which has continued throughout 2012/13, enjoyed a good attendance.

### **Transaction reporting**

The FSA took action against two firms in the last year for transaction reporting failings – Plus500UK Ltd and James Sharp and Company

During 2012/13 Plus500UK Ltd and James Sharp and Company were fined £205,128 and £49,000 respectively for failing to provide accurate and timely transaction reports to the FSA

Between 29 June 2010 and 5 November 2011 Plus500, an online CFD trading facility provider, conducted 1,332,000 reportable transactions. The firm, however, failed to report any of these accurately and omitted entirely to report 189,000 transactions

Between 5 November 2007 and 8 February 2011 James Sharp and Company, an independent stockbroking firm, failed to report any of the approximately 71,000 reportable transactions that it undertook

Both firms' systems and controls were inadequate in that they did not have any documented procedures in place for transaction reporting and failed to provide any relevant training to staff. They therefore breached rules in SUP 17 of the FSA Handbook and Principle 3 of the FSA's Principles for Business

James Sharp and Company were fined under the old penalties policy but Plus500 were the first regulated firm to be fined for transaction reporting failings under the new FSA penalties policy which came into force on 6 March 2010. This policy was established to provide a consistent and more transparent framework to calculate financial penalties. As a result the penalty imposed on Plus500, which was based on the number of affected transactions, was larger than it would have been under the previous regime

These fines are a reminder that firms subject to the transaction reporting regime, regardless of size, should comply at all times with their obligations

### **CASS**

The 2012/13 *Business Plan* set out the FSA's commitment to strengthen further its intensive regulatory and supervisory approach for firms holding client money and safe custody assets and increase its knowledge and oversight of the UK market

The FSA made progress against these commitments by

- Further increasing the specialist regulatory and supervisory resources dedicated to client asset protection in the FSA
- Completing an additional 14 firm visits (51 vs 37 visits) and an additional 13 desk based reviews (70 vs 57 reviews) during 2012 compared to 2011
- Fining two firms for breaches for failures in protecting their client assets. BlackRock Investment Management was fined £9,533,100 and Christchurch Investment Management was fined £26,600 for breaching our Principles and rules in relation to the adequate protection of client money
- Publishing a total of nine papers to make specific enhancements to the CASS regime, in particular CASS 5 for General Insurance Intermediaries, improvements to the Client Money and Assets return (CMAR) and reporting regimes, implementation of the CASS resolution pack and changes that will need to be implemented through EMIR
- Actively engaging with IOSCO regarding the protection of client assets in going concerns and with FSB ResG for resolution of complex cross border failures

### **Industry engagement**

The FSA also made progress against its commitments through engagement with industry. It held a Client Assets & Markets Conference where messages relating to CASS failings were delivered and attended the Asset Management Conference to run CASS-specific workshops. It also worked more closely with the CF10a persons of all CASS Large firms.

There were still fundamental and significant failures in the ability of some firms to properly identify and segregate clients' money and assets, but the large attendance at both conferences and the specific interest shown in CASS were clear indicators that the FSA's messages had an effect and that the industry has heightened awareness of the standards required.

#### Risk methodology

The CASS Unit further developed the FSA's risk methodology using CMAR and Client Asset audit data. These data sources feed directly into its processes to prioritise workloads that align to its risk appetite. Under the new regulatory regime, all CMAR returns are monitored monthly and all annual audits are reviewed for content.

#### Special Administration Regime (SAR)

The CASS Unit continued to liaise with the Administrators of Lehman Brothers regarding potential returns to UK clients. The FSA also monitored those firms that were put into the SAR in late 2011 and early 2012 to monitor the effectiveness of this new process.

The FSA assisted the Government appointed independent reviewer of the SAR in assessing whether the SAR has met its objectives. The FSA shared its experiences from recent administrations as well as the feedback from its wider review of the client assets regime.

#### **Review of CASS regime**

In September 2012, the FSA published a consultation paper setting out a number of discrete proposals and discussion on the wider changes to its regime to achieve better results in the event of insolvency of a firm holding client money and custody assets (client assets). This paper stated that the objective of the review was

- Improving the speed of return of client money and assets following a failure of a firm
- Minimising the market impact of a failure of a firm that holds client money and assets
- Achieving a greater client assets return for clients following a failure of a regulated firm

The proposals to permit porting were made in December 2012 and came into effect in January 2013. This allows the supporting margin held at clearing houses to be ported alongside the client positions to which they relate in the event of failure of a clearing broker. This change, in line with European regulatory developments (namely EMIR), should help reduce the market impact of an insolvency of a clearing broker.

#### **Wholesale conduct supervision**

##### *Development of supervisory approach*

Wholesale conduct is the term used to describe how market participants interact with each other and conduct their business in wholesale markets (banking, insurance and securities) including trading or dealing on markets and the behaviours of regulated firms in their dealings with non-retail clients. It refers to the activities of participants in wholesale markets, not to a defined population of firms.

The new supervisory tools and processes that have been developed for conduct supervision generally are as relevant and applicable to work in relation to wholesale as to retail markets. The approach adopted was based on the principles that the FSA have previously identified and communicated, and over the year the FSA ensured that the new tools and processes that were developed for conduct supervision were embedded in its wholesale conduct supervision activities. The move to twin peaks supervision in April 2012 enabled the FSA to bring a greater focus, especially in wholesale and investment banking markets, to conduct aspects of supervision and towards the end of the year it focused on finalising aspects of the approach to conduct supervision that the FCA will bring in as they apply to wholesale markets.

#### *Business Model and Strategy Analysis (BMSA)*

During the year the FSA developed wholesale content for the new BMSA approach for C1<sup>2</sup> firms including the 'deep dive' modules (governance, product and pre-transaction, sales/transaction, post sales/transaction) which we are now applying to a wholesale C1 group. The C2 Peer Group BMSA approach was also adapted to accommodate wholesale activities: the approach is activity-based, i.e. the peer groups are focused on certain activities and contain respective business lines of all firms involved in such activity. The approach for C3 firms has been adapted so that that approach is applicable to wholesale as well as retail firms. More focus has also been given to wholesale conduct supervision in event driven work, and wholesale metrics for the risk ranking tool for crystallised risks. The FSA also designed and agreed a new approach to group supervision which assumes that risks will be addressed in the same way in standalone firms and the sectoral business units of large firms.

#### **Enforcement action**

In November 2012 the FSA fined UBS AG £29.7 million for systems and controls failings that allowed an employee to cause substantial losses totalling US\$2.3 billion as a result of unauthorised trading. The trader, Kweku Adoboli, has been convicted of fraud and sentenced to seven years' imprisonment in a high profile case.

### **Domestic policy initiatives**

#### **Listing rules**

In October 2012 the FSA published a Consultation Paper (CP12/25) *Enhancing the effectiveness of the Listing Regime and feedback on CP12/2*. In the first part of the paper the FSA set out its feedback to CP12/2. This proposed changes to the Listing Rules, Prospectus Rules and Disclosure Rules and Transparency Rules that it had identified as necessary to ensure the operational effectiveness of the Listing Regime was maintained. The second part of CP12/25 proposed changes to enhance the effectiveness of the regime, in response to market debate about the standard of the premium listing.

The proposals represent a significant enhancing of the Listing Rules in the area of governance and centre around four key elements:

- Optimising the entry criteria to the Premium segment so as to maintain the strength of the Premium Listing brand
- Ensuring that the eligibility requirements continue to apply as meaningful on-going obligations
- Clarifying the operation of the free-float provisions
- Providing shareholders with better quality information

<sup>2</sup> <http://www.fsa.gov.uk/static/pubs/other/fca-factsheet.pdf>

The FSA also worked closely with the Department for Business, Innovation and Skills (BIS) and the Treasury to support the Government's response to the Kay Review of UK equity markets and long-term decision-making

## **ATLAS**

In the FSA's 2012/13 *Business Plan*, it said that developing new IT systems for the UKLA would enable a more efficient allocation of resources, and position the UKLA to respond more flexibly to the dynamic market environment. Following on-going delays to this work, a lack of confidence in the forecast delivery date, and competing resourcing pressures across the IT portfolio, this year the FSA decided to focus instead on the remediation of the existing UKLA systems. Where possible it ensured that the design work undertaken by the project to date has been complete to enable it to be used should the FCA seek to develop new systems in the future.

### **Listing rules – enforcement action**

This year the FSA took enforcement action in five Listing Rules cases reflecting a continuing focus on ensuring appropriate information is given to the market and the regulator in a timely manner.

In March 2013, the FSA fined companies in the Prudential Group (Prudential) a total of £30m for breaching FSA Principles and UKLA Listing Principles. The fines related to Prudential's failure to inform the FSA at the appropriate time that it was seeking to acquire AIA, the Asian subsidiary of AIG, in early 2010. The FSA has also censured Tidjane Thiam, Prudential's Group Chief Executive. This was the first time a serving CEO of a FTSE 100 company had been censured by the FSA. In April 2012, the FSA fined Exillon Energy plc £292,950 for failing to identify related party transactions and disclose them to the FSA in a timely manner.

Also in March 2013, the FSA fined Lamprell plc £2,428,300 for significant failings in its systems and controls, resulting in a failure to identify and disclose inside information in a timely fashion, leading to Listing Rules and other related breaches. This action followed a fine, in February 2013, of £175,000 against Nestor Healthcare Group Limited for failure to take all proper and reasonable steps to secure compliance with the Model Code, a breach which can lead to a perception that individuals within a firm might be misusing information not available to the market. In October 2012, the FSA banned John Blake, managing director of Welcome Financial Services Limited (Welcome), and fined him £100,000 for providing false and misleading information to the market.

### **Regulated Covered Bonds (RCB)**

The UK RCB regime was introduced in March 2008 by the Treasury and supplemented by legally enforceable directions and guidance set out in the RCB sourcebook. Under the regime, issuers must ensure that there is timely payment of claims attaching to the regulated covered bonds, and that the asset pool is of sufficient quality to give investors confidence that, if an issuer fails, there will be a low risk of default in the timely payment by the owner of claims attaching to the bonds.

In January 2013 amendments to the RCB Regulations and RCB sourcebook were introduced to promote transparency and improve investors' understanding of the RCB regime. Under the regime, issuers must ensure

*that there is timely payment of claims attaching to the regulated covered bonds, and that the asset pool is of sufficient quality to give investors' confidence that in the event of the failure of the issuer there will be a low risk of default in the timely payment by the owner of claims attaching to the bond*

In discharging its supervisory duties, the FCA monitors each programme's ability to meet the regulatory requirements and regularly assesses each issuer's fitness to comply with its obligations under the regime

### **Financial Resources Requirements for Recognised Investment Exchanges (RIEs)**

In February 2013, the FSA implemented changes to its guidance on how recognised investment exchanges should meet their financial resources requirements. The guidance, as amended, modernised the FSA's approach by moving to a risk-based regime under which RIEs apply stress and scenario-testing tools to calculate an appropriate capital requirement. The FSA consulted RIEs and other interested parties on its proposals through CP11/19, before confirming the changes in July 2012 and working with the RIEs during a subsequent transitional period.

### **Fit and proper regime for Small Payment Institutions (SPIs)**

The failure in October 2010 of Crown Currency Exchange Ltd, which was registered by the FSA as a SPI under the Payment Services Regulations 2009 (PSRs), highlighted the limited powers the FSA has under the PSRs to control the entry of such businesses. The Treasury consulted on the options for improving the protection of consumers within the payment services industry and subsequently laid amendments to the PSRs before Parliament on 10 July 2012, which came into force on 1 October 2012. The PSRs now require those involved in the management of, and with qualifying holdings in, SPIs – for both new applicants, and those registered before 1 October 2012 – to submit to a 'fit and proper' test similar to that applied to Authorised Payment Institutions. Since 1 October 2012 the FSA assessed new SPI applicants against the fit and proper test for SPIs, and began to develop a regime for incumbent SPIs.

## **International policy initiatives**

### **MiFID II and Markets in Financial Instruments Regulation (MiFIR)**

The FSA worked with the Treasury on the negotiation of the MiFID II and MiFIR. It is expected that both pieces of legislation will be finalised in 2013.

The aim of the changes to the existing legislation are to contribute to delivering enhanced transparency of financial markets and reduced systemic risk, ensure that EU financial markets are robust and resilient in the face of technological change, ensure that commodity derivative markets provide robust and consistent price discovery mechanisms, and enhance existing levels of consumer protection.

The FSA also began work, through various different Standing Committees at the European Securities and Markets Authority (ESMA), on collecting information to facilitate the role ESMA will play in drafting technical standards and advising the Commission on delegated acts under the framework legislation.

### **Market Abuse Directive (MAD) and the Market Abuse Regulation (MAR)**

The FSA worked with the Treasury on negotiating the review of MAD which we expect to be finalised in 2013/14. It began work, through the Market Integrity Standing Committee at ESMA, on considering the issues under MAR in areas where ESMA is mandated to draft technical standards and guidelines and where it is expected agreement will be reached during dialogue negotiations. The new legislation (MAR) seeks to widen significantly the scope of instruments covered (including those traded on MTFs and Organised Trading Facilities as well as Regulated Markets), expand the dealing and manipulation prohibitions, including prohibitions against attempted manipulation and manipulation of benchmarks, and strengthen the investigatory and sanctioning powers of competent authorities across the EU.



### **High frequency trading**

Using transaction data the FSA identified the firms most likely to be engaging in high frequency trading and algorithmic trading, along with platforms where such firms operate. This study sought to understand better the risks such firms pose to the FSA's objectives and their compliance with FSA requirements. We assessed the firms based on the FSA's existing rules in conjunction with the ESMA guidelines on automated trading.<sup>3</sup> This work has helped inform the supervisory approach to similar firms.

### **EMIR**

The FSA supported the Treasury in negotiations to finalise the EMIR regulation and made a significant contribution within ESMA to develop the Technical Standards to support the final implementation of the regulation. On 16 August 2012 EMIR came into force and will require anyone who has entered into a derivatives contract to report and effectively risk-manage their derivative positions including by central clearing if the derivative is standardised.

The FSA started working both with existing regulated financial firms and non-financial firms that fell within its regulatory remit for the first time, to support the implementation of the EMIR within the UK during 2013, and develop robust and proportionate supervision of firms in line with the G20 commitments.

In the *2012/13 Business Plan*, the FSA drew particular attention to the need to develop internationally consistent standards and it also participated in the international BCBS-IOSCO Working Group on Margin Requirements. This group issued two consultations in July 2012 and February 2013 to support the development of internationally consistent margin requirements for non-cleared over-the-counter (OTC) derivative trades.

### **OTC derivatives**

The FSA chaired the OTC Derivatives Regulators' Forum (ODRF) where international regulators discuss derivatives reforms around OTC derivatives central counterparties (CCPs) and trade repositories. During the UK's chairmanship of the ODRF, the FSA implemented arrangements for the cooperative oversight of ICE Clear Europe's credit default swap (CDS) clearing service and LCH Clearnet Ltd's SwapClear interest rate swap clearing service.

The FSA also implemented, through the ODRF, an oversight protocol for DDRL, a UK based trade repository for credit, equity, interest rates and foreign exchange derivatives.

The FSA co-chaired the IOSCO Task Force on OTC derivatives and played an active role in monitoring the workstreams, regulatory developments, and investigative proceedings related to the CDS markets as requested by G20 and IOSCO Board.

The FSA was involved in the development of the Legal Entity Identifier (LEI) system which has the objective of introducing unique identification of parties to financial transactions, including OTC derivatives. The FSA was a member of the LEI Regulatory Oversight Committee which was launched in January 2013 and is responsible for overseeing and upholding the governance principles of the global LEI system.

### **Resolution mechanism for failing CCPs and Financial Market Infrastructure (FMI)**

During 2012 UK authorities worked closely to develop a domestic statutory resolution regime for UK based CCPs and related group companies. This legislation is in place and the regime will take effect

<sup>3</sup> [http://www.esma.europa.eu/system/files/esma\\_2012\\_122\\_en.pdf](http://www.esma.europa.eu/system/files/esma_2012_122_en.pdf)

once the statutory instruments have been finalised UK authorities also developed a proposal for a new recognition requirement, which would oblige UK based CCPs to adopt loss allocation rules and recovery plans. The Government published an informal consultation earlier in 2013 on this proposed recognition requirement and UK authorities will work together to review responses and to appropriately progress this workstream. In parallel, the FSA continued to work with UK based CCPs and their clearing members to promote the voluntary adoption of loss allocation arrangements ahead of any statutory developments.

The Committee on Payment and Settlement Systems and IOSCO developed a resolution working group in 2012, which was chaired by the FSA. The group developed a report on the recovery and resolution of FMI published in July 2012.

### **Commodities**

The FSA gave specific focus during the year to ensure that commodity derivatives markets remain efficient and liquid, and ensure that regulators have appropriate information and powers to supervise them effectively. With this in mind the FSA

- Supported the Treasury in the negotiation of relevant new and amended directives and contributed to commodities related aspects of the EMIR, MiFID and MAD Reviews and working with other Government stakeholders on commodities issues
- Chaired the ESMA Commodities Task Force, which focused on preparatory work in anticipation of receiving mandates to develop technical standards under MiFID II
- Continued to co-chair, with the Commodity Futures Trading Commission, the IOSCO group on commodity derivatives, which was formally upgraded to a Standing Committee in 2012. The group published two papers in October. First, the final report on principles for oil price reporting agencies<sup>4</sup>, representing a significant milestone in the wider international regulatory focus on benchmarks. Second, a review of the implementation of the principles for the regulation and supervision of commodity derivatives markets<sup>5</sup>
- It also looked ahead to the implementation of the Regulation on Energy Market Integrity and Transparency legislation timed for summer 2013 that will affect the approach to market conduct in the commodities markets and took steps to begin revising policies and procedures to take account of the changes.

### **Short selling regulation (SSR)**

The FSA implemented the short selling regulation (Level 1), which became directly applicable in the UK from November 2012. The SSR prohibits firms from

- entering into naked short positions in shares and sovereign debt unless they have arrangements in place with a counterparty to ensure delivery of the stock at the delivery date,
- entering into naked short positions in sovereign CDS, and
- the nominal threshold levels at which firms would be required to notify us of their net short positions in relation to holdings of sovereign debt and sovereign CDS were also set at this stage.

Following delivery of the Level 2 binding technical standards in early 2012, the UK implemented processes for issuers to make the following notifications and disclosures from 1 November 2012

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4 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD391.pdf>

5 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD393.pdf>

Additionally two Q&As were published by ESMA in October 2012 and January 2013 and the FSA assisted on drafting the ESMA guidelines on Market Maker and Primary Dealer Exemptions that was published on 1 February 2013

The FSA was given the power to instigate prohibitions on short selling in instruments that fall significantly in price and it used this power twice in response to prohibitions by other competent authorities

### **Credit Ratings Agencies (CRA's)**

CRA's continue to be subject to considerable regulatory scrutiny because of the widespread use of ratings. A European framework of regulation was developed in 2009. It has subsequently been updated with ESMA now carrying out the registration and supervision of CRA's

In 2011, the European Commission proposed further enhancements to the European regulations on CRA's to reduce mechanistic reliance on credit ratings, improve the frequency and transparency of sovereign debt ratings, eliminate conflicts of interest and enhance competition between ratings agencies. The FSA supported the Treasury throughout the negotiations and the new Regulation was agreed on 16 January 2013. The FSA also supported ESMA in developing the technical standards needed for implementation.

### **Corporate governance for listed issuers**

In December 2012 the EU Commission published proposals (the EU Corporate Governance Action Plan) to strengthen some aspects of corporate governance for listed issuers. The Plan sets out a range of initiatives which will, if taken forward, be implemented through changes to existing directives. The FSA continued to work with the BIS and the Financial Reporting Council on this issue.

### **Prospectus Directive**

In preparation to implement the measures in the Prospectus Directive Amending Directive in the UK by 1 July 2012, the FSA published its joint Policy Statement, PS12/9, with the Treasury in May 2012. This gave feedback from the consultation paper CP11/98, published in December 2011, and set out the changes the FSA made to the Prospectus Rules and which the Treasury made to the Financial Services and Markets Act 2000, in order to implement the Prospectus Directive Amending Directive.

The FSA worked with ESMA on developing Technical Standards arising from the Prospectus Directive Amending Directive in relation to the ESMA CP on Supplements, which was published in March 2013.

## Section four: Delivering consumer protection

### Introduction

The FSA had a statutory objective to secure an appropriate degree of protection for UK consumers. It did this through the way that it authorised, supervised and enforced against regulated firms and approved individuals, and in how it responded to emerging risks and tackled sector or thematic issues. The FSA also used lessons learnt from behavioural economics to understand better how consumers make financial decisions and what impact this had on firms' behaviour and how it regulated them.

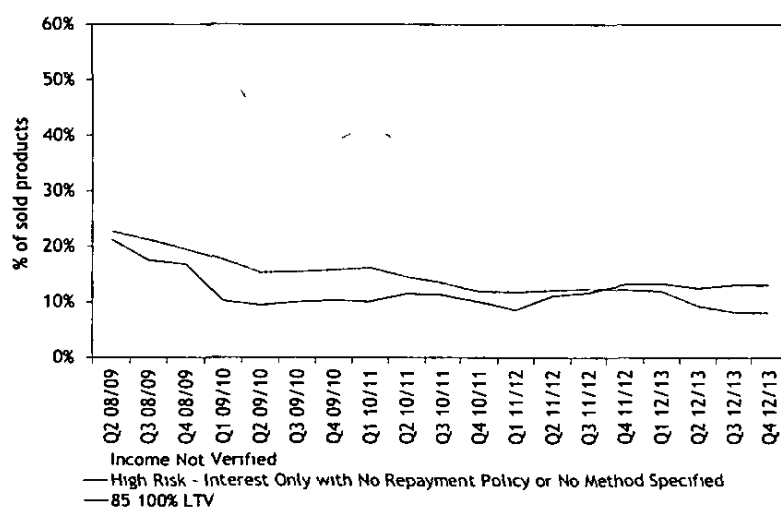
This chapter sets out how the FSA delivered on the 2012/13 *Business Plan* aims, set out as

- Supervisory initiatives, including development of the supervisory approach, product intervention, Retail Distribution Review (RDR) implementation and Mortgage Market Review (MMR) implementation
- Domestic policy initiatives, including work on redress, engagement with the banning of referral fees and the with-profits review
- International policy initiatives, including work on Packaged Retail Investment Products (PRIPs), Undertakings for Collective Investment in Transferable Securities Directive (UCITS) (UCITS), Alternative Investment Fund Managers Directive (AIFMD) and compensation and dispute resolution directives

### Key metrics

The FSA used a wide range of metrics to assess and measure its work. These include

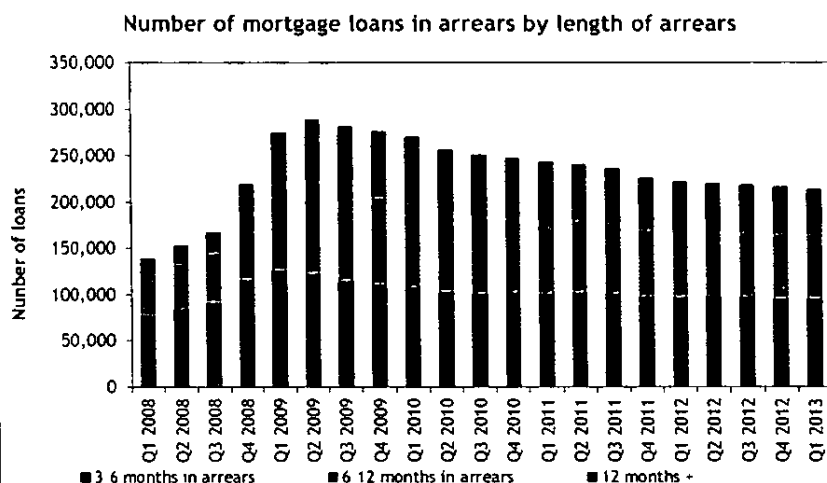
**Chart 1: Higher risk mortgage indicators**



Overall, during 2012, the FSA saw a continued reduction in unverified-income market share and an increase in less risky repayment methods. There were small fluctuations across LTV banding, with mortgages with LTV of 90%+ stabilising at around 22% and LTVs of 85% to 90% at around 11%. These trends may be due to the prolonged financial crisis and the associated reductions and uncertainty in real incomes, and/or to lenders' attempts to preserve income margins through reducing risk.

High-risk interest-only mortgages with no repayment vehicles in place declined for five quarters in a row, from 12.4% in Q3 11/12 to 8% in Q4 12/13

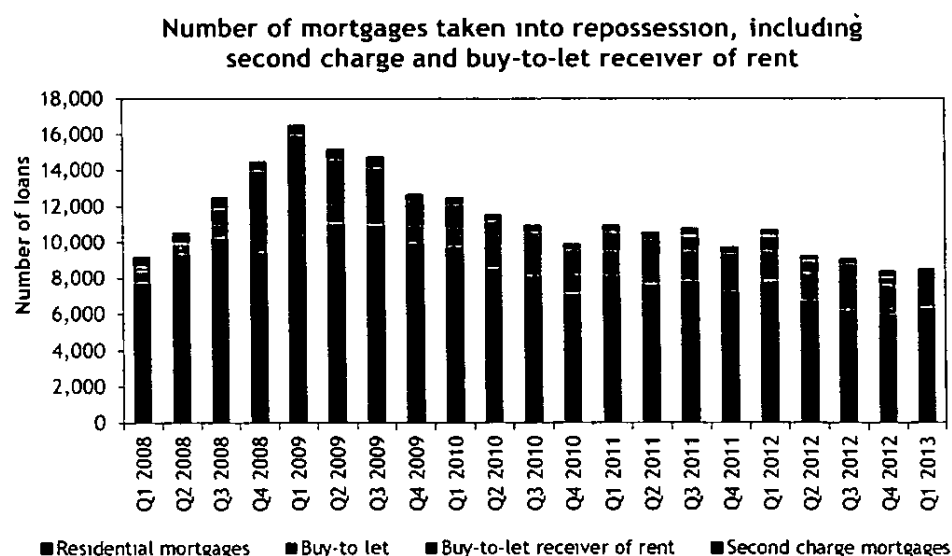
**Chart 2: Number of mortgages in arrears by length of arrears**



Source: CML

Arrears over three months have continued to fall over the last year, down to 1.91% (Source CML) of total outstanding mortgage loans at the end of 2012, the lowest rate since Q4 2008. Residential long-term arrears have flattened off since the beginning of last year and repossessions have been falling steadily. The number of second charge repossessions has seen some increase over the last few quarters and is back up to levels seen at the end of 2011.

**Chart 3: Number of mortgages in repossession**

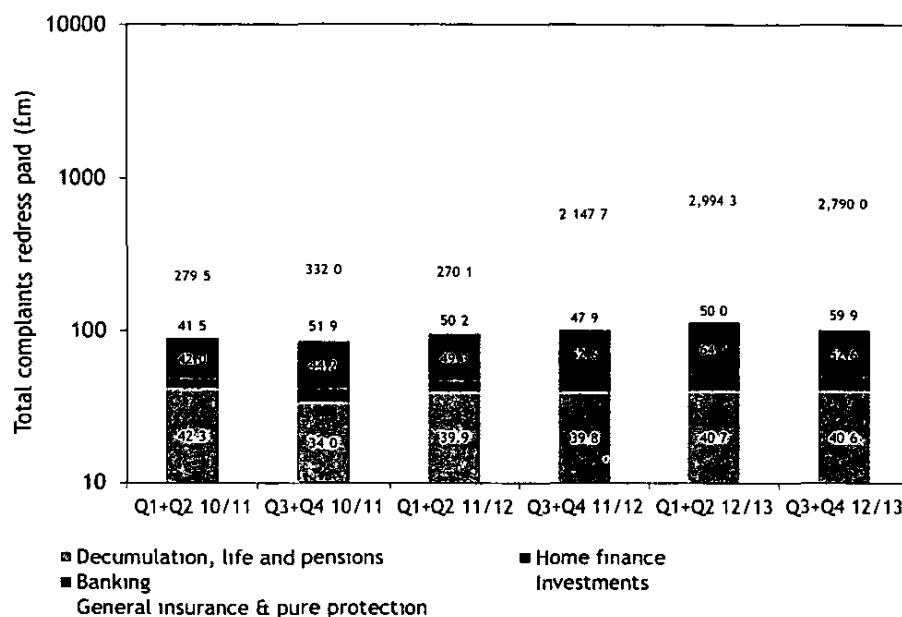


Source: CML, FLA

CML and FLA figures show that repossessions for 2012 were down to 37,328, their lowest level since 2007. The number of voluntary repossessions continues to rise to now accounting for 30% of total.

repossessions CML data indicates widespread forbearance with declining repossessions as a percent of mortgages in serious arrears (over six months) The fall in repossessions as a percent of arrears over six months is well below the peak seen prior to FSA intervention and the fall in interest rates in early 2009 The current repossession rate has changed little since 2011 and is comparable with the rate of forbearance seen after the 1990s housing crash

**Chart 4 Redress paid by firms**

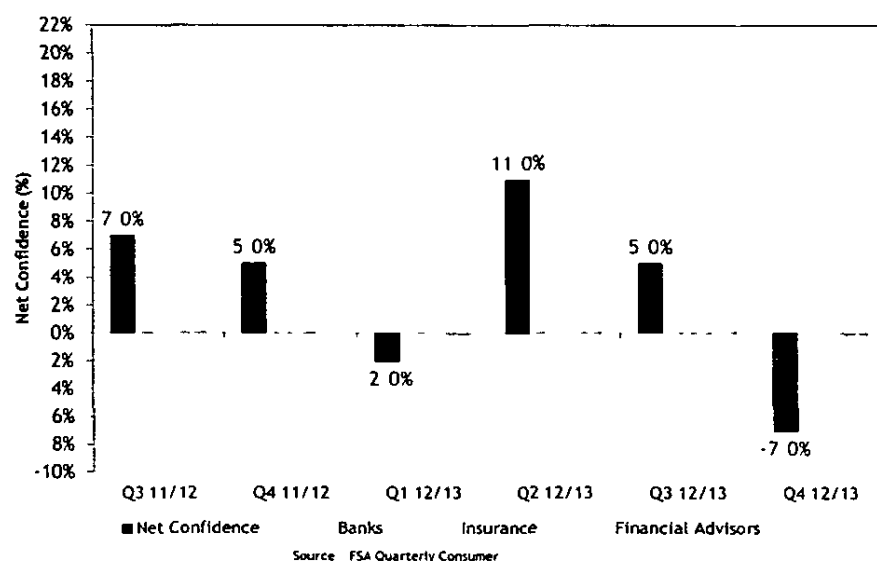


The above chart shows the amount of redress reported in the complaints returns up to the end of the FSA's financial year and split by firm type

The amount of redress in Q3 and Q4 12/13 was 7.4% down on the previous period (2012 Q2 and Q3) but 29.1% up on the same period last year. Redress paid for decumulation life and pension products fell by 27.8% on 2012 Q2 and Q3 and banking products' redress decreased by 19.7%. Redress for home finance products increased by 3.9% and investments by 23.2%.

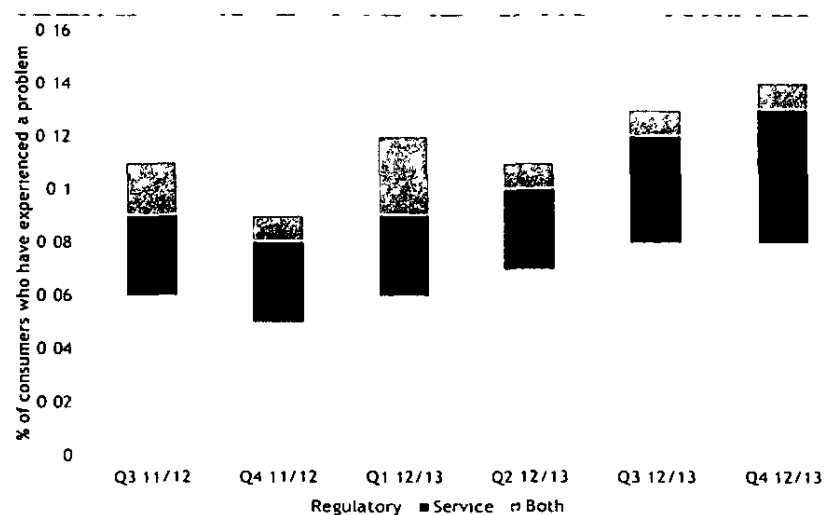
Redress for GI and pure protection products (which includes redress for PPI) accounts for just under 95% of the total amount of redress in the latest period compared to around 51% at the start of the series in 2009 Q3 and Q4. Although GI and pure protection redress was 30.5% up on the same period last year, it fell by 7.7% on 2012 Q2 and Q3.

**Chart 5 Percentage of respondents to the Consumer Awareness Survey (CAS) who are confident firms are treating their customers fairly**



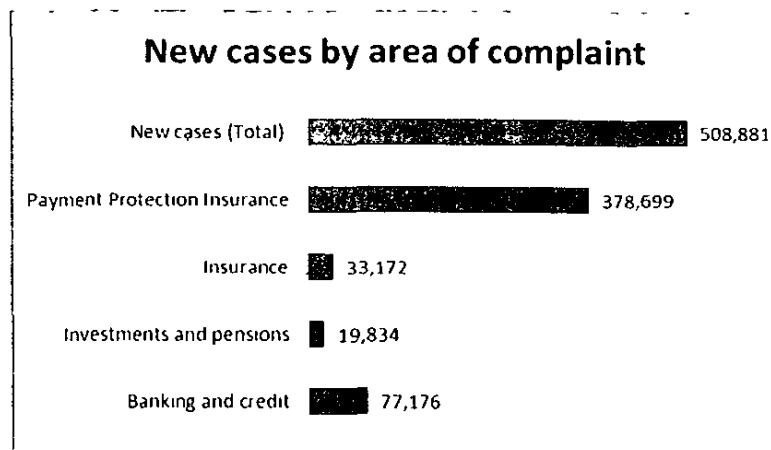
This FSA research, which takes a snapshot of consumer attitudes to how firms are treating them, shows that consumer confidence suffered a large fall towards the end of the FSA's financial year, in contrast to expectations earlier on in the year that firms were treating customers more fairly. There is a net fall between the last two quarters. This is mainly driven by the fall in the confidence in banks – with 25% of consumers reporting little confidence in banks – up from 20% in December. There are smaller falls in confidence in insurance providers and financial advisers.

**Chart 6 Percentage of respondents to CAS who experienced any problems with a financial firm in the last 12 months**



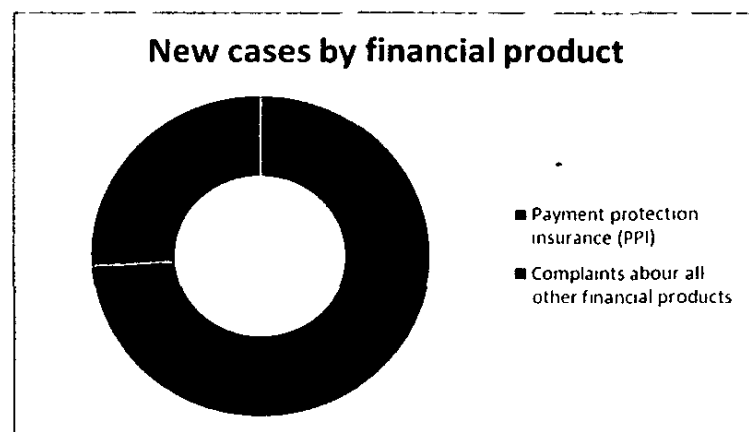
The number and type of problems faced by consumers rose slightly over the year. The most commonly reported problems related to conduct/service issues (9% in the final quarter of the FSA's Financial Year) such as rude or unhelpful staff and problems getting through to people on the phone. There was an increase in those reporting long queues in branches but a fall in reports of complaint handling and problems relating to bank charges.

**Chart 7: New cases reported to the Financial Ombudsman Service**



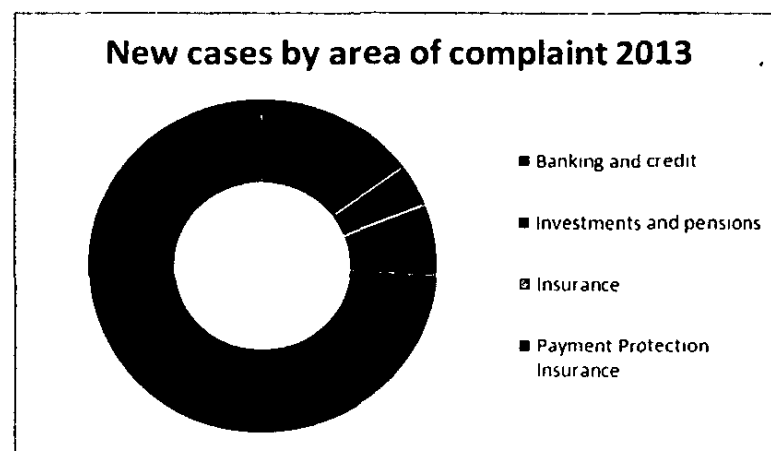
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**Chart 8. New cases reported to the Financial Ombudsman Service the by financial product**



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**Chart 9. New cases reported to the Financial Ombudsman Service by area of complaint 2013**



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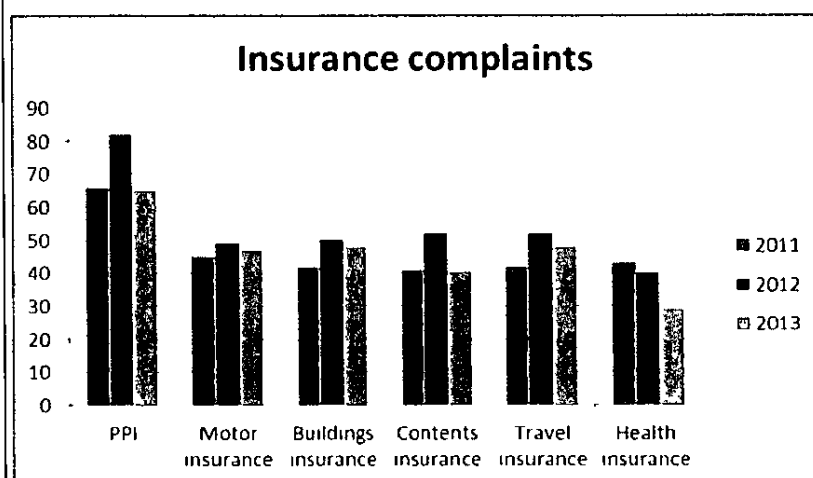
Over the last year, the ombudsman service handled 2,161,439 initial enquiries and complaints from consumers – over 7,000 each working day. Around one in four of the initial consumer enquiries they received turned into a formal dispute – a record 508,881 new cases, up 92% on the previous year.

74% of new cases were about the sale of payment protection insurance (PPI), with the number of PPI complaints rising 140% to 378,699.

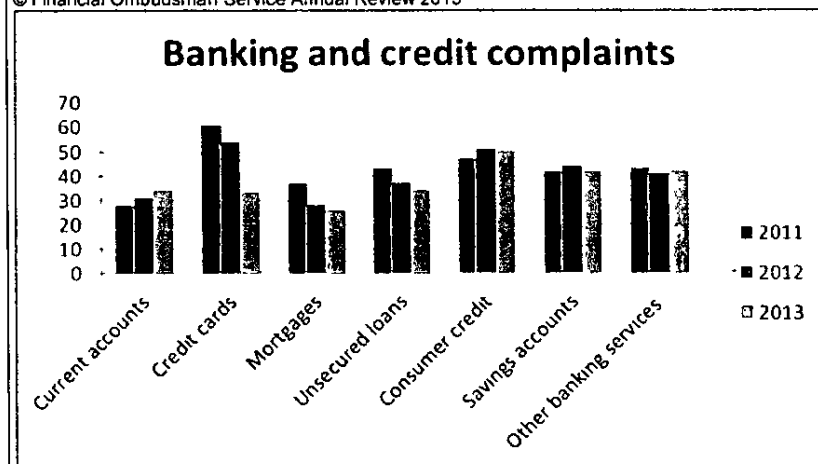
Investment-related complaints increased by 33%, while banking disputes and complaints about insurance other than PPI rose by 20% – resulting in the highest ever numbers of these cases.

62% of the total number of cases we dealt with related to four banking groups – while 4,819 businesses accounted for just 3% of the ombudsman service's caseload.

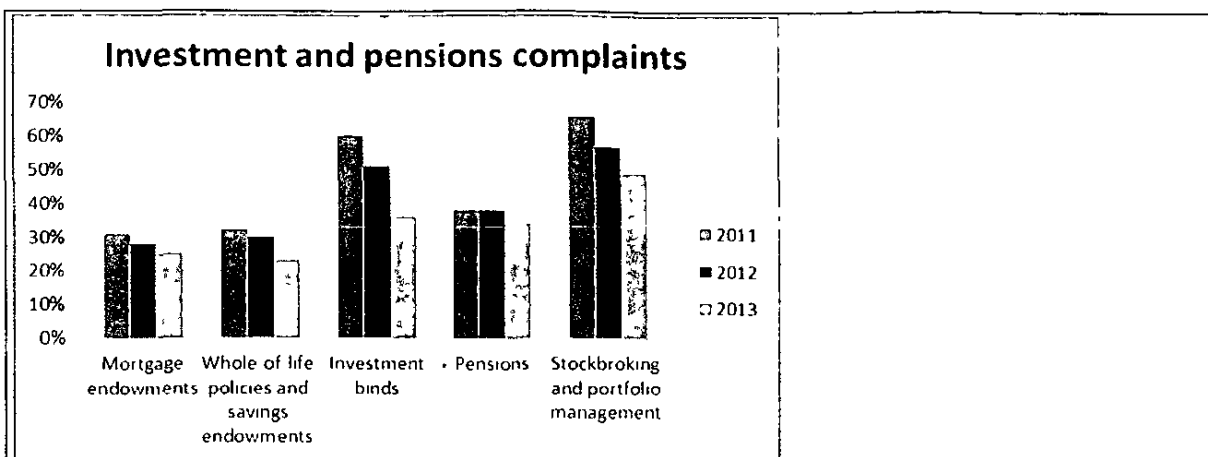
**Chart 8: % of cases upheld by the Financial Ombudsman Service**



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In total the ombudsman service upheld 49% of the consumer complaints which they settled in the financial year 2012/2013

This figure varied across complaints involving different financial products. For example, during the year the ombudsman service upheld

- 65% of PPI cases – where some financial businesses are still not following the well-established approach to handling complaints and putting things right
- 25% of complaints about mortgage endowments – where we found that most consumers had been warned in the mid 2000s about a possible shortfall and had left it too late to complain

The proportion of cases which the ombudsman upheld in favour of the consumer varies substantially from business to business – between 3% and 100%

## Supervisory initiatives

### Developing a supervisory approach

In 2012/13, the FSA developed and started to implement its new approach to conduct supervision. The model is designed to support a judgement-based and pre-emptive approach that is focused on delivering consumer protection.

The model is built around three clear pillars: Proactive Firm Supervision (Pillar 1) – assessing whether firms are run in a way that results in the fair treatment of customers, Event Supervision (Pillar 2), which addresses significant crystallising or crystallised conduct risks at the firm level, and Issues Based Supervision (Pillar 3), which addresses specific conduct risks at a product or sector level. The FSA also developed an approach to prudential supervision for those firms that will be solely regulated by the FCA.

Supporting the model is the development of a new approach to firm classification for conduct supervision, to ensure that a differentiated supervision process that is proportionate to the potential impact of the firm can be applied. A firm's classification drives the intensity of supervision. Firms were informed of the new classifications and what this means for them in March 2013.

BMSA is central to the proactive firm assessment (Pillar 1) with its purpose of identifying the key conduct risks that come from a firm's business model and strategy. In the last year the FSA completed a number of bespoke business model analyses, starting with the largest banking groups, with the output used to shape its firm supervision strategies and work programmes. For other larger

firms the FSA developed a peer group approach to business model analysis across different sectors. These peer group analyses have been used to identify outliers and take action where significant issues were found.

A key aspect of proactive firm supervision are 'deep dives', designed to support the overall assessment of the extent to which firms embed fair treatment of customers. The 'deep dives' cover key areas of a firm's operation, including governance and the product life cycle from design through to post-transaction handling, allowing us to focus on the root causes of problems. A number of these deep dives have been completed to date. Where the work found issues these were tackled promptly.

#### **Enforcement action**

To support the increased focus on issues and products work across firms and sectors the FSA made enhancements to its approach. This includes ensuring this work is clearly driven by sector risk assessments based on its analysis of what is currently and prospectively driving poor outcomes for consumers. The FSA delivered key pieces of thematic work through the implementation of this enhanced approach. In 2012/13, it imposed 51 fines, totalling £423m, 11 public censures and 42 prohibitions.

Supervision's strategy has been supported by taking enforcement action where it is believed that firms and approved persons fail to comply with regulatory requirements, including where

- firms fail to treat their customers fairly,
- customers have been mis-sold financial products, or
- firms have failed to implement systems and controls to mitigate risks to customers

For example, some cases where enforcement action was concluded this year were

- The FSA censured Black and White Group Limited (Black and White), fined the former CEO and Chairman and banned the former Chairman and COO for failings in relation to the sale of mortgages and payment protection insurance (PPI) following a Tribunal decision which concluded that Black and White failed to treat its customers fairly by encouraging staff to focus on sales rather than considering whether the products were suitable for customers
- The FSA published Decision Notices relating to Arch Financial Products (AFP), Robin Farrell, AFP's Chief Executive and Robert Addison, a senior partner and compliance officer at AFP, for failing to manage conflicts of interest and exposing investors to the risk that the funds would not be able to liquidate their investments to meet redemption requests. The matter has been referred to the Upper Tribunal, which will determine the appropriate action for the FCA to take
- Bank of Scotland was fined £4.2m for failures in its systems that meant that it held inaccurate mortgage records for 250,000 Halifax customers for considerable periods of time. This resulted in customers not receiving important information about changes to the terms and conditions of their mortgages. Bank of Scotland put in place a programme to rectify the fact that some customers had received potentially confusing information about changes to their standard variable rate mortgage contracts. While monitoring a consumer forum website, the FSA found a number of customers complaining that they had been wrongly excluded from the programme. In total, approximately 160,000 customers who were due good will payments totalling approximately £162m were excluded
- The FSA took action against Peter Cummings, former Executive Director of HBOS plc, and Chief Executive of its Corporate Division. It imposed a penalty of £500,000 and banned him from holding any senior position in a UK bank, building society, investment or insurance firm for failing to exercise due skill, care and diligence by pursuing an aggressive expansion strategy within the Corporate

Division without suitable controls to mitigate the risk and for failing to take reasonable care to ensure that the Corporate Division adequately and prudently managed high value transactions that showed signs of stress

### *Retail banking*

The FSA continued the transition to a more forward-looking, judgement based conduct supervision model for retail banks and building societies

Within the retail banking supervision area it rolled out an approach to analysing firms' business models and strategies to understand whether these business models are sustainable and to identify future conduct risks to customers. A number of bespoke analyses for the largest banking groups were completed. For medium-sized banks and building societies a peer group approach was used to identify firms with 'outlier' business models. Examples of the types of concerns identified through this analysis included profitability in key areas of a firm's business being dependent on very ambitious growth or cross-selling, predictions of aggressive cost cutting and products being developed without clear target markets, clear features or pricing. The FSA challenged firms on the potential for significant risks to customers as a result of these strategies and took action where it found issues or to prevent problems getting worse.

The FSA invested considerable supervisory time in challenging banks' senior management on their approach to understand the 'tone from the top'. In addition to the more traditional focus on systems and controls, it also considered how culture is embedded within the retail banks. Weaknesses in firms' governance and controls around conduct risks and a lack of consideration of the impact of issues on retail customers continued to be consistent themes in the retail banking sector.

For the largest groups, the FSA completed 'deep dive' assessments in key areas of retail banks' business such as governance, product design, sales and post-sales. This allowed supervisors to understand whether fair treatment of customers was being embedded in the way banks run their business. Where the assessment work found issues these were tackled to prevent problems getting worse and also focused on understanding and fixing the root causes of the problems.

It has been very encouraging to hear firms talking positively about the importance of managing their conduct risks and engaging with the need for cultural change. Overall, however, it is not yet clear that firms in the retail banking area can demonstrate they are consistently putting their customers' interests at the heart of their business.

In addition to supervisory work with individual firms the FSA delivered thematic and mitigation work on key issues that related to a number of firms in the retail banking sector. These projects are described in more detail below and included continuing work on payment protection insurance, review of the sale of interest rate hedging products, mystery shopping on quality of investment advice, review of wealth management services offered by retail banks, and mitigation of risks on core banking and payments services.

### *Smaller firms*

The FSA continued to deliver its four year rolling assessment programme for small firms, completing four out of the total of 12 regions. The programme includes workshops and proactive regulatory reviews with firms. The FSA completed the development of the online review tool – which the FCA will use to assess the lowest risk firms. It conducted two pilots of the online tool with firms during the year and full roll out will progress during 2013/14.

### **Enforcement action in small firms**

In 2012/13, the FSA took 39 actions against small firms and their senior managers. It took action against 25 individuals, banning 23 and fined them a total of £1.32m. It also fined nine firms a total of £1.67m and in four cases it cancelled firm's permissions and censured one firm.

One of the FSA's priorities for 2012/13 was investigating the mis-selling of investment products such as Unregulated Collective Investment Schemes (UCIS) and the mis-use of self-invested pension plans. For example, in October the FSA fined Martin Rigney of Topps Rogers £117,330 and banned him from the financial services industry for mis-sales of UCIS. The FSA further broadened its approach with action against

- a credit union and its CEO (the Pentecostal Credit Union and Reverend Carmel Jones) for diverting funds to other church organisations rather than lending to members,
- the mortgage lender Cheshire Mortgages Corporation, which we fined £1.2m and took action against its directors and
- Gracechurch Investments, a stockbroking firm, and its directors for pressure selling

### **Threshold conditions**

A number of firms do not meet the basic standards needed to carry out the activities for which they have obtained authorisation – the so-called "threshold conditions". There was a team dedicated to taking action against these firms – in the last year, 36 firms have had their permission to conduct regulated business cancelled, and a further 162 firms took remedial steps to address breaches of the threshold conditions following action from this team. Similarly, the team took action against payments services firms, 19 of which have had their registrations cancelled for basic failings, and a further 60 firms have remedied breaches of the minimum standards. Recurring breaches related to lack of adequate resources (including Professional Indemnity Insurance and financial resources) and failures to comply with Ombudsman awards, non-co-operation with the authority, and non-submission of regulatory returns and non-payment of fees.

### **RDR implementation**

The RDR came into force on 31 December 2012, one of the main requirements of which is that advisers can no longer receive commission from providers for advice and must meet new professionalism standards, including completion of higher qualifications. In the period up to implementation, the FSA provided support and, where necessary, greater clarity for the industry (including a number of industry newsletters) and monitored firm and adviser readiness. This ensured that firms were ready for the significant change brought about by the implementation of the RDR. The FSA also engaged with trade bodies and consumer groups before the implementation date to help them prepare for the change.

A number of waiver applications were received in relation to the new qualifications requirement, and over 100 applications were granted where there have been exceptional circumstances that have prevented the completion of qualifications. 47 applications were withdrawn and ten have been rejected. The FSA also published a factsheet to inform consumers directly of the changes. Now that the rules are in force, thematic work is being carried out by the FCA to monitor compliance with the rules and check how firms have incorporated them in their business models.

The FSA successfully implemented a comprehensive set of processes, tools and systems to enable it to supervise compliance by the industry with the RDR rules. Some of the key outputs include

- changes to the FSA's internal business processes allowing us pro-actively to identify potential rule breaches,
- changes to the FSA's strategic IS systems to capture and analyse the additional regulatory data submitted by firms,
- development of business operated solutions to assist with data capture and analysis, and
- design of a supervision strategy that will help measure compliance with the RDR rules and proactively manage market risks

### **MMR and other mortgage work**

The final package of MMR reforms was published on 25 October 2012, and will come into effect on 26 April 2014. One exception to this was the introduction of a new provision designed to prevent the unfair treatment of those borrowers who find themselves 'trapped' with their current lender, which came into immediate effect.

The FSA started its implementation programme, working closely with industry to ensure the new MMR regime is in place at implementation. It completed a series of intermediary and lender roadshows and meetings between January and March, and continued to track firms' readiness.

The MMR and its implementation took priority over the planned reviews of the regulatory approach to Third Party Administrators and of charging practices in the mortgage market.

At an EU level, the Mortgage Credit Directive has remained under discussion throughout the year. The FSA continued to support the Government in these negotiations.

### **Product intervention**

In 2012/13 the FSA continued its work developing the product intervention strategy.

The new provisions setting out specific product intervention powers for the FCA are a key, high profile part of the Financial Services Act 2012, and the FSA supported the development of these provisions through the legislative process. As part of the preparatory work for the FCA, the FSA issued a consultation paper on the FSA's Statement of Policy on making temporary product intervention rules (as required by the 2012 Act). The FSA considered that the ability to make these rules will be an important part of the FCA's toolkit, enabling it to intervene earlier to protect consumers. By publishing the Consultation Paper, the FSA provided industry and consumer organisations with the opportunity to offer their views and feed into the policymaking in this area, and for the FSA to provide some clarity around the circumstances in which temporary rules might be used.

The FSA also advanced its thinking on developing a product governance framework, and tested ideas for a new product governance regime. These ideas are in development and the FCA will continue to work on this project in 2013.

The FSA also actively supported the introduction of an EU approach to product governance and product intervention. In particular, it was active in discussions that provided for a product intervention framework in the MiFID and MiFIR. The FSA was also supportive of the EU Parliament's proposals for product governance measures in the revised MiFID.

### **Financial promotions**

Over the last year the FSA reviewed 7,345 financial promotions for compliance with its rules. Of those that were in breach, it took forward the medium high and high risk cases. This resulted in 199 financial promotions being amended or withdrawn.

## **Engaging with firms and consumers on banking/payments issues**

The FSA remained focused on ensuring that customers are getting fair outcomes from firms in relation to the delivery of core banking and payment services. The FSA acted where firms have failed to meet the requirements of the banking conduct regime, including

- Working successfully with the largest banks and building societies to ensure that where customers' payments are rejected during overnight processing due to insufficient funds, they are re-tried later in the day. It is estimated that this change will remove approximately £200m lost each year to consumers through unpaid item fees as they can now pay in funds on the day to meet the payments and avoid these charges
- Changing the behaviour of the largest debit card providers to ensure that they act on all requests from customers to cancel future dated payments (including recurring transactions/ Continuous Payment Authorities). The FSA reviewed debit card providers' approaches with a particular focus on the problem area of payments due to payday lenders. It worked closely with Citizens' Advice to understand and tackle the problems their customers have experienced
- Undertaking follow-up testing to ensure consumers are benefitting from the increased speed and efficiency of payments, ensuring payments reach their destination by the end of the next working day after the payment was made, and, that when receiving funds into their accounts, consumers are given immediate access to those funds
- Continuing to review whether firms are meeting their obligations to immediately refund unauthorised, fraudulent transactions on customers' accounts and taking action where necessary
- Taking action where individual firms have not met the standard time of 15 days for transferring cash ISAs

Carrying out an initial review of the rapidly developing market for mobile banking and payments in order to understand the risks that these services pose for customers and to tackle potential concerns at the point where firms enter the market or develop their mobile banking/payments services

## **Mystery shopping investment advice on retail banks**

The FSA carried out a mystery shopping exercise looking into the quality of banks and building societies' investment advice. It used mystery shopping to gather first-hand evidence of what someone looking for investment advice from a bank or building society might experience. The results show that, while approximately three-quarters of customers received good advice, there were concerns with the quality of advice in the other quarter. In response the firms involved cooperated and agreed to take immediate action. This includes retraining advisers, making substantial changes to their advice processes and controls for new business, and undertaking past business reviews to identify historic poor advice and put this right for customers. Firms were also required to employ an independent third party to either carry out or oversee this work. One firm was referred to Enforcement.

## **Critical infrastructure**

In response to the IT failures at RBS<sup>6</sup> that affected the bank's customers in June and July 2012, the FSA commissioned a review under Section 166 of FSMA into the causes of the failure. More broadly

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<sup>6</sup> RBS (The Royal Bank of Scotland Plc), Natwest (National Westminster Plc) and Ulster Bank (Ulster Bank Limited (for Northern Ireland) and Ulster Bank Ireland Limited (for the Republic of Ireland))

it required the chairmen of all the large UK retail banks to review the resilience of their own systems and mitigation plans and to ensure that critical IT infrastructure is adequately considered at board level

### **Financial incentives**

In 2012/13 the FSA completed its thematic work on financial incentives, published the findings and consulted on draft guidance, which was generally very positively received. It was found that most incentive schemes were likely to drive mis-selling and firms had not been dealing with this properly.

Final guidance was issued in January 2013, when the FSA also confirmed a wider review commencing in Q2 2013 to assess how firms have responded to the guidance and whether they are now managing the risks.

### **Asset managers - conflicts of interest**

The FSA conducted thematic reviews of asset management firms, assessing their arrangements for managing conflicts of interest. Though there were some examples of good practice, it identified that many firms had failed to establish an adequate framework for identifying and managing conflicts of interests. It also identified breaches of the detailed rules governing the use of customers' commissions and the fair allocation of trades between customers. The FSA concluded that most of the firms visited could not demonstrate that customers avoid inappropriate costs and have fair access to all suitable investment opportunities. A Dear CEO letter titled *Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks* was published in November 2012 setting out the findings and expectation. The FSA requested that the CEOs of the largest asset management groups attest to us by 28 February 2013 that their firms comply with FSA rules on the management of conflicts.

#### **Enforcement action – conflicts of interest**

In May 2012, the FSA fined Martin Currie Investment Management Limited and Martin Currie Inc (Martin Currie) £3.5m for failing to manage a conflict of interest between two of its clients. Martin Currie caused one client to enter into an ill-advised transaction that rescued another client from serious liquidity concerns and failed to disclose this conflict to its clients.

### **Wealth management**

The FSA's previous work in this sector resulted in the sending of a letter in 2011 to the chief executives of wealth management firms outlining concerns. It had been found that 79% of the investment portfolios that were reviewed either had a high risk of being unsuitable or the FSA was unable to determine the suitability from the information that the firms held. This year, the FSA followed up that work by looking at the quality of the wealth management service offered by six large banks. The work focused on assessing the suitability of the investment portfolios that the banks created for their customers. It also looked at how the banks ensure that their customers receive the correct investments for their circumstances. The FSA completed the investigation stage of its work and told the banks its findings, which varied significantly across the banks assessed. The banks have cooperated and have agreed to undertake actions to improve the wealth management service for their customers.

#### **Savoy Investment Management Limited and UBS AG – enforcement action**

In November 2012, the FSA fined Savoy Investment Management Limited (Savoy) £412,000 for failing to take reasonable care to ensure the suitability of the investment portfolios of its wealth management clients. Savoy allowed its investment managers a high degree of discretion to advise its wealth management clients on their investment portfolios and had limited controls to ensure the



suitability of its advice and portfolio management. A review of a sample of files found that 23% showed a high risk of unsuitability.

In February 2013 the FSA fined UBS AG £9.45m for failures in its sale of the AIG Life Premier Access Bond, Enhanced Variable Rate Fund (the Fund). UBS sold the Fund to 1,998 customers, with initial investments totalling approximately £3.5 billion. These failures led to UBS customers being exposed to an unacceptable risk of an unsuitable sale of the Fund. In particular, UBS failed to carry out adequate due diligence on the Fund before selling it to customers so UBS had an inadequate understanding of the nature of the Fund's assets and the consequent risks. UBS also failed to deal properly with complaints from customers about sales of the Fund.

### **Low value general insurance**

Mitigating customer detriment arising from the design and sale of General Insurance products of potentially limited value was a supervisory priority in 2012/13.

The FSA used its full supervisory and enforcement toolkits to identify poor consumer outcomes. The FSA took robust action against a number of firms for failures in their products, sales and post-sales handling.

Its intervention has led some firms to

- cease selling certain products,
- change products to remove misleading features,
- amend sales scripts, and
- deliver additional staff training.

The FSA worked to deliver redress for customers where products have been mis-sold. It has also used its powers under Section 166 of FSMA to identify the root causes of unfair sales practices in individual firms and then taken action to mitigate current and future customer detriment.

### **Card Protection Plan (CPP) Limited – enforcement action**

In November 2012, the FSA imposed its joint largest ever retail fine of £10.5m on CPP for mis-selling its insurance products.

The FSA found widespread mis-selling of CPP's two main UK products, card protection and identity protection insurance. CPP sold its card protection product by emphasising that customers would benefit from up to £100,000 worth of cover for fraudulent transactions on lost or stolen debit and credit cards. However, this cover was not needed because customers were already covered by their banks. CPP also overstated the risks and consequences of identity theft during its sales of identity protection. Overall, the FSA found that, while CPP's products were relatively inexpensive, they were mis-sold widely and CPP encouraged its sales agents to be overly persistent. This case highlighted concerns about low cost insurance that offers little or no value to the customer.

### **Motor Legal Expense Insurance (MLEI)**

The FSA conducted thematic work into MLEI. MLEI is the most common 'add-on' to motor policies, typically sold at £25 to £30. The FSA's consumer research showed that, though people have high awareness of the product, they have very little understanding of it. A thematic project concluded that the product is useful in packaging together the legal services to enable consumers to pursue their legal rights to recover their uninsured losses following a motor accident for which they were not at fault. However, the explanation of the product needs to improve at all stages in the sales journey – from comparison websites to policy wordings.

In line with the FCA's stated intention of taking regulatory action quickly the FSA provided early feedback, both to individual firms and to senior industry figures at a seminar on 19 February 2013. This new approach was welcomed by firms and has yielded good results. All the firms that took part in the project have agreed to amend their business practices as required. Either as a result of feedback to the FSA or their own internal reviews four major insurers are stopping 'opt-out' selling of MLEI and other add-ons. The FCA will review industry practices again in a year.

### **Domestic policy initiatives platforms**

Following a comprehensive programme of research, which included consumer research (among those who use platforms), business model analysis of platform service providers and competition analysis, the FSA published CP 12/12 in June 2012. This proposed that platform service providers (in both the advised and the non-advised markets) should be remunerated only by a platform charge paid by the consumer. The FSA engaged extensively with the industry and received 80 responses to the consultation. The FCA published PS 13/1 on 26 April which confirmed our final rules.

### **With-profits review**

The rule changes introduced in Policy Statement 12/4 intended to improve the governance of with-profits funds and tightened further some of the discretions exercised by companies and others that provide with-profits funds. The FSA also launched a consultation at the end of 2012 on with-profits mutuals so they can present a case for continuing to write new insurance policies without having to go into run-off, subject to their demonstrating fairness to policyholders and policyholder protection through sufficient security of policyholder benefits. This work will continue, with an FCA Policy Statement expected later on in the year.

On 18 October 2012, the FSA fined Sun Life Assurance Company of Canada (UK) Limited £600,000 for failing to establish and maintain adequate governance arrangements for its with-profits business during 2008 and 2009. These failings included Sun Life executing two significant derivative transactions without adequate review and approval from Sun Life's with-profits committee and its board of directors.

### **Referral fees**

From 1 April 2013 the payment and receipt of referral fees in England and Wales was banned. The ban has been implemented by the Legal Aid, Sentencing and Punishment of Offenders Act 2012.

Before this there was an extensive firm-facing communications plan and a 'one minute guide' prepared. These provided the industry with a high-level insight into the FCA's supervisory approach and interpretation of the ban, including reference to the FSA's coordination with other regulators.

### **Financial Services Compensation Scheme (FSCS)**

During 2012, the FSA completed an in-depth review of a representative sample of firms to assess whether deposit takers have the systems in place to provide data to the FSCS so that it can pay most depositors within seven days of their bank, building society or credit union failing.

In May 2012 the FSA issued requirements on firms to improve consumer awareness of FSCS cover for deposits, following which we required deposit takers to display prominently stickers and posters in branches and on websites (in electronic form) explaining the compensation arrangements.

It also made rule changes to help the FSCS when the value of a claimant's investment is uncertain. The FSA gave the FSCS some additional flexibility in appropriate circumstances to pay full compensation where, under present rules, consumers would have to wait an excessively long time to receive full compensation.

The FSA also continued to work closely with the FSCS and the FOS in the area of consumer protection, including timely exchange of information in relation to breaches of its requirements, industry trends and financial failures (at risk and crystallised), and, where appropriate, it shares the intelligence and insights gained through its supervisory work

### **FSCS funding**

In July 2012 the FSA published CP12/16, setting out proposals for a review of the FSCS's funding arrangements. A well-funded and sustainable compensation scheme is important for financial stability and consumer confidence, and all financial services firms benefit from this

The objective in formulating the new funding model was to establish a credible funding approach for the FSCS, one that balances the need for adequate funds with affordability for those contributing. Consultation Paper 12/16 *FSCS Funding Model Review* set out

- proposals for change, and
- an explanation for those areas where we proposed to retain the current approach

The FSA confirmed final rules in January 2013 (FSA CP13/1), except the rules on funding the FCA retail pool, for which it issued a further short consultation and subsequently confirmed the final rules in March (FSA PS13/4)

The key new features of the model include

- Revised annual thresholds based on assessments of affordability
- A retail pool that would be triggered if one or more FCA classes reached their annual threshold (i.e. the limit that funding class would be expected to contribute in any one year)
- Where the retail pool is triggered by costs arising from the FCA FSCS intermediation funding classes, all FCA-regulated deposit takers, general insurers, life insurers and home finance providers must also (in addition to the FCA FSCS funding classes) contribute to the pool
- With effect from 1 April 2014, the potential for the FSCS to smooth the impact of levies by looking further ahead at potential compensation costs expected in the 36 months following the levy instead of 12 months, as at present

### **Consumer engagement and insight**

Maintaining good links with a range of external consumer bodies has helped the FSA gain insight into the problems faced by consumers. Connections with these groups also helped the FSA communicate with consumers. These bodies, including Money Advice Service, form an important part of how the FSA carries out its duties to consumers. Dialogue with consumer groups forms an important part of the FCA's strategy going forward

In 2012/13 the FSA developed a consumer organisation network. This comprises of consumer organisations from across the UK that meet twice a year

The members are

- Citizens Advice England
- Citizens Advice Wales
- Citizens Advice Scotland
- Citizens Advice Northern Ireland

- Money Advice Scotland
- The Consumer Council of Northern Ireland
- Advice UK
- Age UK
- SCOPE
- Which?
- Money Advice Trust
- Stepchange
- Toynbee Hall

The network has the following objectives

- 1 Establish and maintain productive and trusting relationships with consumer organisations
- 2 Create improved flows of information and insight between consumer organisations and the FSA

The FSA also established consumer insight training that provided FSA staff with an insight in to the needs and vulnerabilities of UK consumers. Further training to provide staff with an understanding of consumer behavioural biases when selecting products will continue under the FCA.

The FSA's Consumer Helpline continued to provide guidance to members of the public who have questions or concerns about their financial provider or about a financial product. The Consumer Helpline received calls on a wide variety of topics such as general insurance, investments, and banking as well as calls regarding scams or other financial crimes. Other enquiries this year included topics such as LIBOR, the eurozone and Payment Protection Insurance (PPI).

#### **Engaging with consumers**

In between meetings the FSA used various methods of engagement with a range of consumer organisations within and outside of this network. It aimed to work with consumer representative organisations in ways which recognise their limited resources to engage with it. The FSA recognised that in order to look at regulation from a consumer's point of view it needed to work closely with consumer organisations so it can understand issues and emerging problems.

As part of its engagement work with consumer organisations the FSA held a day-long event engaging with young people in Govan, Glasgow, to understand what mattered to them when it came to using financial services. To ensure the FSA got the most from this event it worked in partnership with the national Scottish youth charity Young Scot. The FSA also spent a day with the Women's Institute to hear from their members what they expected from a financial conduct regulator.

#### **Customer Contact Centre – Projects and people**

This year, work was undertaken to improve the service provided to the FSA's customers – both firms and members of the public from our firm and consumer contact centres. This involved a wholesale review of the quality assurance process, which is a framework for continuously monitoring whether it provided customers with the information they required in a clear, accurate and timely manner.

The new framework quickly identified areas where the FSA could improve its service and enabled it to target additional technical training for our contact handlers, ensuring it gave accurate and informative responses to enquiries, and ultimately provided a better service. The FSA saw an 82% increase in productivity in responding to correspondence, and it maintained its call productivity. The FSA

continued to build on the breadth and depth of staff knowledge in the Contact Centres throughout 2012, for example, this helped it to significantly increase the productivity of its correspondence teams

It is important for the people who contact the regulator to have trust in the answers and guidance that it provides. The Customer Contact Centre gained full accreditation to the Customer Contact Accreditation's Global Standard, which has helped enhance trust.

The FSA also successfully delivered a project to set up a firm enquiries function in the BoE to take prudential calls.

## **Redress**

Since December 2010 the FSA has secured £320m in redress and payments to consumers in relation to cases where it has taken enforcement action.

### *Arch Cru*

In December 2012 the FSA announced a redress scheme for investors in CF Arch Cru Funds. The FSA concluded that there had been widespread mis-selling by IFAs who failed to assess the funds as high risk despite the fact that they were typically invested in non-mainstream assets such as private equity, private finance and commodities.

The FSA published a Policy Statement on 17 December 2012 outlining the implementation of a consumer redress scheme for investors in the CF Arch Cru fund range. This followed on from the Consultation Paper it issued in April 2012 describing its proposals for a consumer redress scheme in relation to widespread mis-selling of Arch Cru funds by financial advisers. The FSA's analysis reviewed 179 files from a random sample of 24 firms and identified that the advice was unsuitable in 78% of cases, primarily because the funds were high risk and many consumers were not willing or able to take this level of risk within their portfolio.

The consumer redress scheme rules were introduced on 1 April 2013. Under the scheme rules, firms must write to consumers inviting them to have their advice reviewed. If consumers opt-in to the scheme, then firms are required to review the advice by 9 December 2013 and pay redress where the advice is deemed unsuitable, and consumers have suffered a loss as a result of the advice.

### *Interest Rate Hedging Products (IRHPs)*

In 2012 the FSA carried out a review of the sales of IRHPs by four of the largest UK retail banks to small businesses. The results of this review identified significant failings including the inappropriate sale of complex varieties of IRHPs to 'non-sophisticated' customers and a range of poor sales practices. In June and July 2012 the FSA announced that ten banks had agreed to conduct a proactive redress exercise and past business review in relation to their sales of IRHPs to small businesses. Each of the banks' reviews would also be overseen by an independent Skilled Person appointed using powers granted to the FSA under Section 166 of FSMA. Following an initial pilot exercise in late 2012 the banks are expected to progress to the full review exercise in 2013.

### *PPI*

Ensuring appropriate redress is paid to those who were mis-sold PPI remained a priority for the FSA. Over the course of this financial year its focus moved from educating and assisting firms in understanding its complaint handling measures to monitoring firms to ensure they were delivering fair redress in practice. As a result, consumers received in excess of £6.1 billion in redress over the course of the financial year.

In February 2013 the FSA fined Lloyds Banking Group (LBG) £4,315,000 for failings in their systems and controls that resulted in up to 140,000 customers receiving delayed PPI redress. LBG failed to establish an adequate process for preparing redress payments to send to PPI complainants and, as a result, LBG's systems were unable to process the very large volumes of PPI redress payments that it needed to make in a timely way. In addition, there were deficiencies in LBG's monitoring of PPI redress payments and LBG's approach to risk management when preparing the payments to send to PPI complainants was ineffective.

The FSA also fined The Co-operative Bank plc (Co-op) £113,000 for failing to handle PPI complaints fairly. During the British Bankers Association unsuccessful high court challenge of FSA measures, which were published in 2010 and designed to ensure that all PPI complainants were treated fairly, Co-op incorrectly put on hold PPI complaints that were capable of being progressed. Co-op put these complaints on hold, despite the FSA making it clear to the industry, that many claims could be progressed normally as the judicial review was in progress. The FSA's review of a sample of complaints that were put on hold revealed that 100% of the cases examined could have been progressed.

#### **Keydata update**

The FSA's disciplinary proceedings against Keydata and its former CEO were put on hold in late 2010 while Mr Ford's judicial review, which concerned his claim to joint legal privilege over a limited category of documents, was heard by the Court. On 11 October 2011, the High Court found that Mr Ford could claim joint privilege with Keydata regarding two of the eight documents being reviewed. On 12 June 2012, the Court made an Order regarding the remedies Mr Ford had requested to the effect that the FSA cannot use these two documents in its disciplinary proceedings. Mr Ford is now seeking permission to appeal this decision to the Court of Appeal, and in the meantime, the disciplinary proceedings remain on hold. FCA work in this area remains a priority.

## **International policy initiatives**

### **AIFMD**

Member States are required to implement the AIFMD by 22 July 2013. The AIFMD aims to

- Mitigate the build-up of systemic risk by enhancing the supervision of Alternative Investment Fund Managers (AIFMs) across the EEA to support timely and pre-emptive action
- Improve investor protection by imposing new depositary standards and enhanced transparency through new disclosure and reporting rules
- Promote competition in the EEA by providing harmonised rules and an EEA-wide passport for full-scope EEA AIFMs to market and manage AIFs from 22 July 2013

The FSA consulted on UK implementing measures, including changes to FSA rules on prudential requirements for fund managers and on the regime for depositaries, in our Consultation Paper (CP12/32), published on 14 November 2012. The FSA published a second Consultation Paper in Q1 2013 on further implementing measures covering subjects such as

- marketing arrangements under AIFMD,
- arrangements to implement the Treasury's proposals for specialised regimes for smaller (sub-threshold) alternative investment fund managers,
- the application of the FSCS and FOS, and
- fee-raising arrangements for all firms within scope of AIFMD

The FSA worked within ESMA to develop technical standards and guidelines on implementing measures related to AIFMD, such as types of AIFMs and Alternative Investment Funds, remuneration of key staff, and reporting requirements for firms, as well as international supervisory cooperation agreements with regulators in major non-EEA jurisdictions

## **UCITS**

The European Commission adopted the UCITS V proposal on 3 July 2012. The proposal focuses on rules around depositaries, remuneration and sanctions and mostly aims to ensure an alignment of UCITS with AIFMD. Working closely with the Treasury the FSA participated in the on-going negotiations in the European Council.

## **Insurance Mediation Directive (IMD2)**

In July 2012 the European Commission adopted a proposal for a revised IMD2. The Commission proposes that the scope of IMD2 be extended to encompass more firms that sell insurance, notably insurance undertakings, as well as introducing new disclosure rules and a higher level of sales standard for insurance investment products - like those in MiFID. The proposal is currently being debated in the European Parliament and Council of Ministers, the FSA worked with the Treasury and the UKRep to provide support and input in the legislative process so far.

## **Packaged Retail Investment Products (PRIPs)**

In July 2012 the European Commission also adopted a proposal for a regulation for a new Key Information Document to be produced by investment product manufacturers and provided to retail customers when they are considering buying certain investment products. The regulation will set common product information standards for various different PRIPs. The proposal is now under negotiation in the European Parliament and Council of Ministers. The FSA worked with the Treasury, and the UKRep to provide support and input throughout the legislative process to date, seeking to influence policy thinking and to ensure a good outcome for investor protection.

## **Payment services and electronic money**

During the year, the FSA worked with the Treasury, and liaised with stakeholders, to form the UK's contribution to the European Commission's review on the Payment Services Directive. The FSA recommended that the review seeks to deliver a simpler, more coherent regulatory structure by reviewing the Payment Services Directives and the second Electronic Money Directive in parallel and incorporating any initiatives arising from the Green Paper on card, internet and mobile payments. The European Commission has accepted the importance of combining the review of the Payment Services Directive with the Green Paper initiatives but has postponed the review of the E-money Directive because it has not yet been implemented by some Member States.

## **Compensation and dispute resolution directives**

### *Deposit Guarantee Schemes Directive (DGSD)*

DGSD requires Member States to establish a deposit guarantee scheme. The UK meets this obligation through the FSCS. As part of this, depositors are protected up to £85,000 (€100,000) per depositor per authorised deposit taker, and the DGSD requires payout to be achieved within 20 working days (though the UK has a target seven day payout for most depositors).

In 2010 the European Commission proposed a recast of the DGSD. This included proposals requiring pre-funding, the use of funds to pay for resolution actions, mutual borrowing between Member States, risk-based levies, a reduction in the payout deadline to seven days, harmonised eligibility criteria and consumer disclosure requirements.

### *Investor Compensation Schemes Directive*

The European Commission's 2010 proposals for amendments to the Investor Compensation Scheme Directive remain subject to negotiation, but the dossier has made no further progress through the EU legislative process since November 2011

Throughout 2012 the FSA continued to work with the Treasury to support its development of a UK strategy for influencing and securing amendments, when negotiations recommence, which

- enable the FSCS to continue to provide investors with at least the existing amount of protection it currently provides, and
- are proportionate and operationally achievable in respect of funding arrangements

### *Dispute resolution procedures*

The texts for a directive on Alternative Dispute Resolution and a regulation on Online Dispute Resolution were agreed informally between the European Parliament and Council in December 2012 and they will be formally adopted by the European Parliament and Council in 2013 Throughout 2012 the FSA worked closely with BIS and FOS to ensure that the proposals maintained existing confidence in the FSA (and FOS) and would not impose a disproportionate burden on industry



## Section five: Financial crime

### Introduction

The FSA had a statutory objective to reduce the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime

In the *2011/13 Business Plan*, the FSA highlighted that credible deterrence and enforcement are at the centre of its strategic objective to reduce financial crime

This chapter sets out how the FSA delivered on its *2012/13 Business Plan* aims, which were

- supervisory initiatives, to engage and encourage the regulated sector to strengthen its defences, using various tools including intensive supervision and thematic reports, and
- other initiatives, including our work on domestic and international policy work, deterring and preventing unauthorised businesses and working with our partners across Government and law enforcement to tackle financial crime

### Supervisory initiatives

#### Thematic reports

In 2012 the FSA published two thematic reports relating to financial crime. Its report on *Anti-bribery and corruption system and control in investment banks* it looked at how investment banks and similar firms manage the bribery and corruption risk in their business. The FSA found that although firms had started work to identify and assess their bribery and corruption risks and factor them into their anti-bribery and corruption controls, most had more work to do to meet regulatory requirements.

The FSA also published a report on *Banks' defences against investment fraud*. The FSA's work in this area highlighted that there was little governance of the specific issue of investment fraud in banks and made recommendations to the industry to address this. Following publication of the report, there was a roundtable at the FSA, both with firms included in the review and others to discuss the findings, make clear our regulatory expectations and debate how to improve industry standards in this area. All attendees, and the FSA, agreed to work together to follow up on a number of new initiatives suggested during the meeting. These included improvements in information sharing and raising consumer awareness. Firms are expected to assess their own systems and controls taking account of the findings from our thematic reviews, including examples of good and poor practice that were also in the FSA's publication *Financial Crime: A Guide for Firms*.

#### Financial crime risk

The FSA successfully designed, piloted and rolled out its Systematic Anti-Money Laundering Programme. This is a new programme of intensive, intrusive supervision to identify money laundering, financial sanctions and terrorist financing risks in the largest banks. Since the beginning of 2012, the FSA conducted detailed reviews of three major UK banks' anti-money laundering (AML) systems and controls. In general, there continues to be weaknesses in banks' management of high money laundering risk situations, including Politically Exposed Person relationships, so this will remain a key part of supervisory focus.

During 2012/13, the FSA also engaged closely with domestic and international standard setters on an effective risk-based approach for AML and counter terrorist financing standards. The FSA supported the Treasury on the revision of the Financial Action Task Force's (FATF) 40 recommendations and the methodology for the fourth round of mutual evaluations. The FSA also liaised closely with the

European Commission on their review of the third Money Laundering Directive and with the European Supervisory Authorities (ESAs), working to address European anti-money laundering issues

#### **Anti-Money Laundering enforcement actions**

The FSA's thematic and supervisory work on Financial Crime is supported through taking enforcement action. In May 2012 it fined Habib Bank AG Zurich (Habib) £525,000 and its former Money Laundering Reporting Officer (MLRO), Syed Itrat Hussain, £17,500 for failure to take reasonable care to establish and maintain adequate AML systems and controls. Habib failed to establish and maintain adequate controls for assessing the level of money laundering risk posed by its customers. As MLRO, Hussain was responsible for overseeing Habib's AML systems and controls, but failed to ensure that these systems and controls were adequate.

In July 2012 the FSA took enforcement action against Turkish Bank (UK) Ltd (TBUK) in relation to its correspondent banking arrangements, fining the firm £294,000 for breaching the Money Laundering Regulations 2007. This fine highlights to firms the importance of maintaining appropriate and risk-sensitive AML policies and procedures, and adequate and on-going due diligence.

#### **Unauthorised business**

The FSA continued to take action against unauthorised investment businesses, including share frauds, landbanking and 'get-rich-quick' investment scams in 2012/13. The FSA received in the region of 6,000 reports each year about unauthorised activity in the UK. It identified the most serious matters posing the greatest risk to consumers and sought to stop them through a combination of methods including bringing legal proceedings against the perpetrators and publishing consumer warnings.

The main types of unauthorised activity that the FSA dealt with in legal proceedings include

- share fraud / boiler rooms,
- landbanking (selling land on the false promise that it will increase in value when it achieves planning permission),
- get-rich-quick schemes offering false high yields, and
- formerly authorised individuals prohibited by the FSA / FCA from working in financial services who attempt to continue their activities under the radar.

The FSA took five civil actions this year and four actions in the criminal courts as well as publishing consumer warnings in respect of 144 unauthorised firms.

The FSA secured a key outcome in the High Court in a case against Asset Land which ran an unauthorised landbanking investment scheme. Asset Land was run by David Banner-Eve and Stuart Cohen, who were found by the High Court to have operated an unauthorised collective investment scheme. Through Asset Land they sold plots of land across the UK on the promise that investors would make substantial profits when the land was re-zoned and given planning permission. The business is believed to have taken around £15m from investors. The FSA took steps to put the companies into liquidation and make the individuals bankrupt in the hope of returning some funds to the firm's victims. Asset Land may well prove to be one of our last big landbanking investigations. Since 2011, reports of landbanking activity have dropped off dramatically. This is attributed to a combination of shutting down 13 of the largest and most egregious schemes together with a concerted consumer guidance campaign on the risks involved in buying land without planning permission from unauthorised firms.

The FSA also secured a significant outcome in a Supreme Court test case against Digital Satellite Warranty Cover Ltd, an unauthorised business offering satellite repair insurance. The FSA argued that the warranty product that the firm sold to the public amounted to a contract of insurance and that

the firm needed to be authorised by us to continue selling it. This will have wider implications for more than 100 other unauthorised businesses that sell similar products to the public.

The FSA also disrupted an unauthorised FOREX trading scheme which netted around £6m from investors through the execution of search warrants and have charged two individuals Alex Hope and Raj Von Badlo for promoting and operating the scheme without authorisation. The FSA restrained £2.7m in bank accounts controlled by Hope under a Proceeds of Crime Act restraint order. The case is currently going through the courts.

#### *Prohibited individuals*

An area that the FSA focused on more this year involved individuals who have been prohibited by the FSA from conducting financial services who attempt to carry on their activities under the radar. It commenced a criminal prosecution against a prohibited independent financial advisor (IFA), Gary Hexley, and another former IFA, John Cooper, for giving investment advice without FSA authorisation. The two men are also charged with dishonestly concealing information about, amongst other things, their lack of authorisation and the suitability of the products that they were advising elderly and in some instances very vulnerable ex-clients to invest in. Both men are due to stand trial for these offences in September 2013. This was followed later in the year by another similar case in which the FSA charged another banned IFA, Michael Lewis, with 13 counts of breaching the General Prohibition and three counts of Assisting a Fraud by False Representation (contrary to the Serious Crime Act 2007 and the Fraud Act 2006).

#### *Investment fraud*

The FSA continued to scan the horizon for emerging trends in investment frauds. The FSA was particularly concerned by the growth of new alternative investment products such as carbon credits and rare earth metals that fall outside current legislation. It worked hard to raise consumer awareness about the risks posed by such products. In April 2012 it wrote to over 76,000 potential victims of investment scams, warning them that they might be targeted by fraudsters.

#### **Working with others to tackle financial crime**

The FSA regularly met with other agencies, such as the Serious Organised Crime Agency, the Serious Fraud Office and the National Fraud Intelligence Bureau, to ensure there is an effective, collaborative strategy for tackling investment fraud and was actively involved in projects coordinated by the Economic Crime Command (ECC) of the shadow National Crime Agency where there is an FCA interest. The FSA was represented on the board, intelligence group, operations group and other principal organs of the ECC. We also kept the Government informed about new trends that involve products that fall outside our remit.

The FSA also continued to dedicate resource to developing its domestic and international intelligence networks.

Domestically the FSA liaised with law enforcement and other agencies on a wide range of financial crime issues, from boiler room scams to pension liberation fraud and market abuse.

The FSA worked closely with law enforcement and regulatory partners across the world on a large number of financial crime and intelligence matters. This has included working with US authorities on money laundering allegations relating to HSBC and Standard Chartered and supporting European law enforcement agencies to bring down a network of boiler rooms that scammed thousands of victims of their money. Intelligence work was key in the successful prosecution of individuals connected with the three insider dealing cases it prosecuted this year, resulting in ten criminal convictions.

The FSA worked closely with the US authorities to understand the implications of breaches by UK banks of their US legal and regulatory obligations, and liaised with both the banks and the US authorities to ensure appropriate corrective action is carried out by the banks

## **Section six: International**

### **Introduction**

International and European work remained an essential part of the work that the FSA undertook reflecting the ever growing European and Global nature of financial services regulation and supervision

In the *2012/13 Business Plan*, the FSA set out its international priorities which were to deliver effective supervision and crisis planning, support an effective international regulatory and supervisory architecture, and play a key part in developing international standards. This section highlights how the FSA delivered on these priorities

### **Effective cross-border supervision**

The FSA continued to lead supervisory colleges for UK firms that have cross-border activities. This included the coordination and running of international supervisory college meetings and joint decisions on risk-based capital adequacy within the EU. For the large UK banking groups it reached joint decisions with EU host supervisors on each firm's individual capital adequacy for 2012 within the four month timeframe set out in CRD. It also continued to participate in supervisory colleges for overseas firms active in the UK, including input into the joint risk assessment and decision process as host supervisor.

A major priority in 2012 was co-leading Crisis Management Groups (CMGs) for each UK G-SIB with the BoE (as the UK resolution authority). CMGs comprise supervisory and resolution authorities from the major countries in which a banking group operates. The FSA worked to meet the FSB's timetable to assess the adequacy of UK bank recovery plans, for CMGs to develop and agree global resolution strategies and to identify and overcome barriers to orderly resolution.

### **Contributing to the international and European agenda**

The FSA was an active member on all global standard setters and ESAs and engaged with key EU institutions such as the European Commission, the European Parliament and the European Central Bank (ECB). It contributed to a number of key European and international workstreams including

- Governance and structure of global standard setters – A number of global standard setters have been undertaking a review of their governance and structure and the FSA contributed to these reviews. This included the establishment of the Financial Stability Board (FSB) under Swiss Law.
- The Financial Action Task Force (FATF) – The FSA took a leading role in the revision of the FATF standards and supporting guidance, to ensure that the risk-based approach to Anti-Money Laundering and Terrorist Financing is firmly embedded in the international standard. The FSA was also part of the FATF President's focus group to review the structure and responsibilities of the FATF working groups and their relationship with the plenary.
- The IOSCO - As of January 2013, 91 IOSCO members had become full signatories of the IOSCO MoU on Cooperation and Exchange of Information – a key achievement that the FSA led through the chairmanship of Committee 4 on Enforcement and Cooperation.
- Reviews of the ESAs – Preparations began for the review of the ESAs that must be completed by January 2014. The FSA worked closely with the Treasury, providing technical input to their preparation for negotiations.
- The Banking Union will have a significant impact on the EU Supervisory Structure, particularly the EBA. The FSA worked closely with the Treasury, providing technical input to their preparation for negotiations.

**Global systemically important institutions**

The IAIS completed a review of its core principles, and the FSA was heavily engaged in its continuing work on the development of a Common Framework for the Supervision of Internationally Active Insurance Groups, and on the identification and treatment of major insurers that might be designated as Globally active Systemically Important Insurers (G-SII)

Similar work was also underway in the Basel Committee on Banking Standards, on identifying G-SIBs and the FSA also chaired the Macro-Prudential Group charged with working on this

**Effective senior and working-level representation**

The FSA was an active member of the EIOPA Board of Supervisors and chaired three of its committees

Martin Wheatley continued as a Member of ESMA's Management Board and the FSA chaired the Secondary Markets Standing Committee and the Commodities and Derivatives Task Force as well as other working level groups

Andrew Bailey gained a seat on the EBA's management Board

At a global level, the FSA held a number of working level and senior positions. Adair Turner sat on the FSB and chaired its Standing Committee on Supervisory and Regulatory Cooperation and Julian Adams was elected as a Member of the Executive Committee of the IAIS

Seconding staff to the European institutions, the ESAs and the global committees was an important way by which the FSA contributed to the EU and global financial services work programme. The FSA seconded staff to the European Commission, EBA, ESMA and EIOPA, the UK's Permanent Representation in Brussels and the IOSCO secretariat

## **Section seven: Delivering the operational platform**

### **Introduction**

During 2012/13, as set out in the *2012/13 Business Plan*, the FSA continued to ensure that it had the right people with the right skills, invested in its infrastructure and delivered the operational changes for the transition to the new regulatory structure

This chapter will set out how the FSA delivered its' operational platform

### **People**

The FSA continued to attract a diverse range of talented people to the organisation mostly due to the exciting change programme and variety of work on offer in the lead up to and implementation of the FCA and PRA. Acceptance rates were exceptionally high, with 95% of all offers made in 2012 accepted by applicants

The FSA also made great strides in equipping senior staff with depth and breadth for the challenges of the FCA and PRA. During the year it strengthened senior staff levels with the recruitment of five new directors and 30 new heads of department to drive new organisational structures following legal cutover. This was achieved using the revised recruitment approach for senior staff and these recruits were assessed against new behavioural requirements

Having hired talented staff, the FSA continued to develop them through training and competency programmes and to see levels of employee engagement in line with high performing companies. To ensure that at cutover the FCA and PRA were well prepared with the right technical skills, the FSA refreshed the supervisory training modules for PRA and FCA bound staff to reflect the changing objectives and approach

### **IS development**

#### **Information Systems Investment Programme (ISIP)**

The FSA started a significant investment in its IS systems and capability this year with the set-up of its ISIP. The core objective of ISIP is to achieve an acceptable level of operational risk to the FSA and successors in relation to their platform and estate. This will ensure continuity of service for key regulatory systems and improve the ability to make changes to these systems

In the *2012/13 Business Plan*, the FSA committed to

- stabilising the technology used by supervisors to analyse data and produce reports,
- starting the process of retendering our outsourced IS services,
- completing upgrades of key applications,
- investing in IS tools and methodologies,
- continuing to ensure the FSA retained IS knowledge and reduced its reliance on contractors, and
- started to develop the future regulatory systems needed to support the work of the FCA

During the year the FSA stabilised two of its key analysis systems – the business intelligence system, which is used to analyse the supervisory data received from firms and produce the reports used by supervisors, and consolidated the product sales data reporting into the GABRIEL strategic platform

The FSA restructured its existing contract for outsourced services with Fujitsu. As well as delivering increased value for money, it now provides greater clarity on service descriptions that can be taken to market, if this course of action is taken in the future

The FSA also completed a refresh of its entire end-user computing estate and rolled out new computers to all staff. This includes rationalising the server estate to create space within data centres and reduce costs. Looking forward to the FCA, the FSA started to replace databases that underpin key regulatory systems such as GABRIEL and the FSA Register. 220 databases for 25 key systems have been identified and scheduled for replacement over the next two years.

To enhance the other areas of the IS Investment Programme the FSA delivered three key workstreams in its IS approach. These were to roll-out a standardised Project and Portfolio Management solution to support delivery of the significant change portfolio, implementation of a suite of system testing tools as the first step of a journey to update the testing approach, and a framework for 'agile' approaches to systems development that is now being rolled out to some key programmes to reduce the time and cost of delivery.

To enhance our knowledge retention the FSA reduced its contract staff, replacing around 70 contractors with permanent staff.

As the vision and objectives for the FCA developed through the year, the FSA also progressed its technology approach. The first steps were to commence the replacement of the telephony infrastructure that supports the Contact Centre and other specialist telephony areas such as Whistleblowing, which helps provide a better service to regulated firms and other stakeholders. The FSA also made some improvements to the existing ONA platform in 2012/13 and started a project that will look to move the ONA service to a more resilient platform.

#### **Operational changes for the transition to the new regulatory structure**

Through the year the FSA conducted detailed planning for the operational delivery of the new regulatory structure. This was successfully delivered at the end of the financial year with the creation of the FCA and PRA.

This required all facets of the operating platform to work together to deliver the changes required. From a people perspective what roles and staff would transfer to each future regulator was determined and 'TUPE-like' transfer of staff to the BoE was conducted. As well as staff we transferred over 1.8 million information records. The transition also included the transfer of office equipment to minimise the costs on the industry.

Underpinning the operational relationship between the FCA and PRA is a Provision of Services agreement with the BoE describing how the FCA will provide support to the PRA. This agreement covers systems support and other services such as fees Collection, enforcement and intelligence services, contact centre and handbook.

#### **Olympics planning and business continuity planning**

The FSA was conscious of the potential disruption that the Olympics could cause to its own operations and the wider financial services sector. Internally, the FSA adapted its approach during the period of the Olympic and Paralympic Games and maintained its business-as-usual activity. Externally, it worked closely with firms to ensure they were well prepared for any disruption. This included a review of contingency plans, implementation of alternate working arrangements and business working patterns to reduce the demands on public transport and successful testing of these plans ahead of the games.



## Section eight - Financial review

### Financial review

#### Basis of preparation

This financial review is based on the FSA's Financial Management and Reporting Framework, details of which are provided at the end of this chapter. Under this framework, net expenditure on core operating activities is identified as Ongoing Regulatory Activities (ORA) expenditure.

**Table 8.1: Reconciliation of statutory accounts to the financial review**

	£m
<b>Net expenditure for the year per the statutory accounts</b>	<b>547.1</b>
<b>Add:</b> Taxation	-1.8
<b>Net expenditure for the year including taxation per the statutory accounts</b>	<b>545.3</b>
<b>Add:</b> difference between accounting charges for pension provisions in the statutory accounts and the related cash costs of pension contributions paid	36.1
<b>Less:</b> reduction in advanced funding reserve in respect of UKLA	-18.4
<b>Less:</b> scope change (treated outside ORA)	-6.1
<b>Less:</b> cost of regulatory reform implementation (treated outside ORA)	-28.7
<b>Net ORA expenditure for the year</b>	<b>528.2</b>

#### Net ORA expenditure

Net ORA expenditure for the year to 31 March 2013 was £528.2m, resulting in an £8.2m surplus against the £536.4m budget. It is reported net of an £18.4m drawdown of UKLA advanced funding, used to fund certain activities within the UKLA and Markets divisions and included within the £40.6m sundry income receipts in Table 8.2.

We also spent £28.7m on regulatory reform implementation and £6.1m on activities that represented additional scope for the FSA. This included work on the transfer of consumer credit, Alternative Investment Fund Managers Directive (AIFMD) and the Retail Distribution Review (RDR). The FCA will recover these costs in future years from entities specifically aligned to these initiatives once they have been implemented.

The tables below analyse the actual and budgeted 2012/13 costs in more detail. The budget reflects the reallocation of funds between cost lines throughout the year to ensure resources were made available for priorities as they emerged.

**Table 8.2 Net expenditure by type**

	2012/13 Actual £m	2012/13 Budget £m	2012/13 Variance £m
Staff costs (including travel, training, recruitment and pension scheme deficit reduction contributions)	380.7	365.3	(15.4)
Accommodation, office services and depreciation	76.7	80.2	3.5
IT costs (including IT delivery outsourcing)	62.9	64.6	1.7
Professional fees	19.9	18.5	(1.4)
Enforcement External Case Costs	10.2	12.6	2.4
Impairment costs	11.4	0.0	(11.4)
Printing, publications and other	7.0	6.2	(0.8)
CEO Contingency	0.0	14.8	14.8
<b>Total expenditure</b>	<b>568.8</b>	<b>562.2</b>	<b>(6.6)</b>
Sundry Income	(40.6)	(25.8)	14.8
<b>Total net ORA expenditure</b>	<b>528.2</b>	<b>536.4</b>	<b>8.2</b>

Staff costs were £15.4m higher than budget reflecting the FSA's decision to make a one-off £22.0m contribution to reduce the defined benefit pension scheme deficit that will be inherited by the FCA and mitigate the risks of significantly increased future annual pension deficit-funding contributions. This was partially offset by a £6.6m under spend, driven mainly by longer recruitment glide paths compared to our budget assumptions, together with underspends on travel and recruitment.

The £11.4m impairment cost over spend reflects the total costs of impairing assets, including £7.3m UKLA project impairments (funded by a release of advanced funding) and £2.0m write-downs of furniture and fittings prior to the release of two floors in Canada Tower at legal cutover.

The £14.8m CEO contingency fund was budgeted to mitigate financial and economic risks which did not arise.

Sundry income was £14.8m higher than budget, driven by the £7.3m release of advanced funding to fund UKLA project impairments and the receipt of unbudgeted special project fees.

### **Panel Costs and the Office of the Complaints Commissioner (included in ORA)**

Total ORA includes £1.0m in respect of the cost of the Consumer Panel (£0.6m £0.4m staff costs, £0.2m other) and the combined cost of the Practitioner and Smaller Businesses Practitioner Panels (£0.4m £0.1m staff costs, £0.3m other). These figures include the costs of people who support the Panels' work, independent research, Panel members' fees and expenses, and costs associated with the preparation of the Panels' annual reports. The overall costs of these panels were in line with budget.

In 2012/13 the FSA provided funding for the Office of the Complaints Commissioner (OCC) in relation to the costs of the Commissioner and his staff, accommodation and ancillary services. The OCC's total costs for 2012/13 were £0.6m, in line with budget.

### **Funding**

We are funded by fees payable by the organisations we authorise, recognise, register or list. During 2012/13 £568.0m in fees was raised directly from those fee payers (2011/12 505.9m).

These comprised £536.4m ORA funding (2011/12 492.0m), £31.6m for Regulatory Reform, £2.4m to fund scope change and £8.2m additional fees (resulting from population and tariff data changes), offset by a £10.6m release of ORA reserves.

### **Financial penalties**

As in previous years we neither budget for financial penalties arising from disciplinary cases nor use them to fund our activities. During 2012/13 we collected penalties of £381.9m (2011/12 £70.7m). In prior years financial penalty receipts were used to reduce the fees levied by the FSA across relevant fee blocks. Following changes made by the Financial Services Act 2012, all financial penalty receipts in 2012/13 net of £38.2m enforcement costs were paid to the Exchequer in April 2013.

**Table 8.3: Funding the FSA's net expenditure**

	2012/13 £m	2011/12 £m
Total net costs for the year per the financial review	528.2	474.7
Under spend against budget (see reserves movement - table x)	8.2	17.3
<b>ORA Budget</b>	<b>536.4</b>	<b>492.0</b>
<b>Additional funds raised</b>		
Regulatory Reform	31.6	10.9
Outcomes-focused regulation transition	0.0	5.0
Scope change funding	2.4	1.6
Additional fee income	8.2	5.4
Movement of reserves to fund AFR reduction	(10.6)	(9.0)
	<b>31.6</b>	<b>13.9</b>
<b>Fees income per statutory accounts</b>	<b>568.0</b>	<b>505.9</b>

## Balance Sheet

### Financial Strength

The FSA had net liabilities of £87.3m at 31 March 2013 (31 March 2012 £66.1m), primarily as a result of pension liabilities of £114.7m, calculated under International Accounting Standard 19 Employee Benefits (IAS 19). Excluding the pension deficit, the FSA had a net surplus of £27.4m.

The pension liabilities will not crystallise for many years and our approach to managing and funding our pension deficit is explained in note 14 to the financial statements.

As at 31 March 2013 the FSA had £392.0m of cash and cash equivalents (31 March 2012 £72.0m) and our average cash balance was £291.2m in 2012/13 (2011/12 £163.9m). Up to 31 March 2012 the FSA made use of financial penalty receipts as working capital; however, under the Financial Services Act 2012, the FCA must pay financial penalties over and above the cost of Enforcement (£38.2m in 2012/13) to the Exchequer.

Nevertheless the FSA has strong fee covenants and a predictable cash flow/ working capital profile. The invoicing of firms is undertaken in three main tranches during the year to ensure

the FSA has appropriate working capital and liquid reserves available to it to settle its liabilities as they fall due and meet its agreed liquid funds criteria. The minimum amount of immediate liquid funds for the FSA/ FCA has been set at a period of 6 weeks' ORA expenditure (£51.4m for 2013/14)

### Movement in the FSA's reserves

The FSA Financial Management and Reporting Framework outlines our plan to keep ORA reserves at +/-2% of ORA budget. This takes into account our broader financial risk management and the ability to draw on our revolving credit facilities.

The movements in the FSA's reserves can be summarised as follows:

**Table 8.4: Reserves/ (Deficits) movements**

	ORA reserves £m	Scope change £m	Advanced Funding £m	Regulatory Reform £m	Pension Reserve £m	Total £m
<b>At 1 April 2012</b>	24.0	(5.0)	22.5	(0.5)	(107.1)	(66.1)
Annual Funding Requirement	(10.6)	2.4		31.6		23.4
Additional Fee income	8.2					8.2
Net surplus	8.2					8.2
Regulatory Reform Cost				(28.7)		(28.7)
Pension Reserve					(7.8)	(7.8)
Movement in Advanced Funding			(18.4)			(18.4)
Costs relating to scope change		(6.1)				(6.1)
<b>Total movement for the year</b>	<b>5.8</b>	<b>(3.7)</b>	<b>(18.4)</b>	<b>2.9</b>	<b>(7.8)</b>	<b>(21.2)</b>
<b>Total statutory reserves at 31 March 2013</b>	<b>29.8</b>	<b>(8.7)</b>	<b>4.1</b>	<b>2.4</b>	<b>(114.9)</b>	<b>(87.3)</b>

### ORA reserves

Our ORA reserves at 31 March 2013 were £29.8m (2011/12: £24.0m). £17.1m (2011/12: £10.6m) of this reserve will be used to reduce the fees we need to collect in 2013/14. When combined with the Regulatory Reform surplus, we will be reducing 2013/14 AFR by a total of £19.5m. The remaining £12.7m is being carried forward as an ORA reserve.

### Scope change

£6.1m costs related to scope change have been separately identified. The £8.7m accumulated expenditure will be recovered by the FCA in future years from appropriate fee blocks.

### Advanced Funding

The advanced funding reserve separately identifies funds collected for specific projects/activities principally related to UKLA and other markets-related activities. The £18.4m

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decrease, primarily used for markets monitoring project expenditure. includes the drawdown for the £7.3m impairment costs, detailed in table x.4

### **Regulatory Reform**

To date, the Regulatory Reform Programme has under spent its budget by £2.4m which will be used to reduce 2013/14 fees. The remaining £2.6m budget for this programme will be incurred in 2013/14.

## **Financial Management and Reporting Framework**

This financial management and reporting framework explains the basis on which the FSA has managed and reported on its costs and funding to 31 March 2013. This framework will continue to be used by the FCA from 1 April 2013 to

- exert sound financial management and budgetary control over all areas of expenditure and income, and
- seek to manage any unavoidable volatility to minimise the year on year impact on fee payers

## **Ongoing Regulatory Activity (ORA)**

These are core operating activities, managed year on year as part of our budget process. The cost of ORA is the key figure, along with the explanation for any material movements which demonstrates how we have met our obligation to be economic and efficient in using our resources.

### **Changes in Scope**

Under certain circumstances, including legislation introduced by Parliament, there may be changes to the scope of activities that we regulate. Any scope changes are subject to financial management as part of our budget process. However until a new supervisory process is established, material activities resulting from a scope change are controlled separately so they are individually identifiable. When the new supervisory requirements of the scope change have stabilised, typically after the new scope has been in place for at least a full year, we include these activities as part of the cost of our ORA.

### **External enforcement costs**

Total enforcement costs, managed within ORA, depend on the number of cases and their complexity. Because of the nature of enforcement cases, actual case costs may be materially higher or lower than the budget set in advance of the financial year. If this happens we will review any excess or reduction in costs from budgeted level and, if appropriate, we will phase the impact on fee payers over a three year period, subject to us being able to maintain satisfactory reserves.

### **Panel costs**

FSA 2012/13 ORA includes the costs of the Financial Services Consumer Panel, Practitioner Panel and the Smaller Business Practitioner Panel. These independent panels manage their own costs against budgets which are subject to our approval and funded through our fees. From 1 April 2013 the Financial Services Act 2012 requires the FCA to establish and maintain the following independent panels: the FCA Practitioner Panel, Smaller Business Practitioner Panel, the Markets Practitioner Panel and the Consumer Panel.

### **Office of the Complaints Commissioner**

The complaints system, required by FSMA, will continue under the Financial Services Act 2012. From 1 April 2013 the Complaints Commissioner will deal with complaints about the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA) and the Bank of England (in respect of its oversight of banking clearing houses and payment schemes). The Complaints Commissioner controls his own costs against a budget which is subject to FCA approval and is funded through our fees. These costs are included within the cost of ORA.

### **Pension scheme deficit reduction contributions**

The amounts required to fund our pension liabilities over time are inherently variable as they depend on factors such as investment values and projects investment returns. We have plans in place to reduce our pension scheme deficit to nil over the ten year period to 31 March 2021. Every three years the Trustee carries out a scheme specific valuation (SSV) which is a detailed valuation using actual asset and liability details. We then agree a recovery plan with the Trustees to close the funding gap. The next SSV will be carried out using data as at 31 March 2013.

### **Reserves**

In line with our Treasury Management Policy we aim to keep cash levels at the equivalent value of six weeks of ORA. We anticipate that we will have sufficient financial capacity within our revolving credit facilities to meet any expenditure required to address unforeseen events. We plan to keep ORA reserves at +/-2%.

### **Financial Risk Management**

In the ordinary course of business our operations expose us to a number of financial risks including credit risk, liquidity risk, inflation risk and the risk from the provision and management of our final salary pension scheme. We have in place a risk-management programme that seeks to limit the adverse effect on our financial performance by monitoring these risks and taking appropriate mitigation action where required. The Financial Services Act 2012 provides us with the power to make rules to levy fees to fund our operations. In doing so we seek to ensure that we operate with due regard to our economy, efficiency and effectiveness as well as seeking to minimise any unnecessary volatility in our fees.

The Board has delegated the responsibility of monitoring financial risk management to the Audit Committee. The policies set out by the Board of Directors are implemented by the finance function (concerning the manner in which transactions are accounted for, the overall management of financial risk and fee invoicing and collection).

### **Credit risk on the collection of our periodic fees**

We charge fees to the persons we authorise, the bodies we recognise, the companies we list and the entities we register. The consultation process we go through in order to set our fees is designed to help ensure that they are set at a level which both reflects the regulatory activity involved and is affordable to all fee payers, large or small. In addition, many of our smaller fee payers use facilities offered by Premium Credit Limited, an independent credit provider to finance the payment of our fees. In such instances, Premium Credit Limited bears the credit risk rather than the FSA/ FCA. The level of unpaid debts is monitored regularly however our exposure to bad debts is minimal and is currently less than 0.3% of fees receivable.

### **Counter-party risk**

The Board has approved a policy for the management of any surplus cash balances that we may hold above the level needed to meet our short term liquidity requirements. Such balances are invested by our agents, Lloyds Banking Group, in high quality, liquid deposits with a range of counter-parties in such a way as to avoid an excessive concentration of our investment with any specific counter-party. Our funds are only deposited with firms that met our minimum investment criteria as assigned by credit rating agencies.

### **Final salary pension scheme**



The most significant financial risk is that the benefits our Pension Plan offers to its Final Salary members will not be matched by the assets available to the Plan. In that case, the residual cost will be met by the FCA. What we are doing to manage those risks is set out in note 14 to the financial statements.

**Currency risk**

We do not have any significant exposure to currency risk.

# Section Nine Report of Directors and Corporate Governance Statement

## DIRECTORS' REPORT

**Table 1**

Name	Board meetings	Additional Board Meetings*	NedCo	RemCo	AuditCo	RiskCo	Original appointment date	Expiry of current term
Amanda Davidson <sup>b</sup>	10/10	4/4	6/6	4/5	5/6		1 5 10	31 3 13****
Sandra Dawson <sup>b</sup>	10/10	4/4	6/6	7/7	5/6		1 5 10	31 3 13****
Peter Fisher <sup>b</sup>	9/10	2/4	5/6			3/5	19 1 07	31 3 13****
Brian Flanagan <sup>b</sup>	9/9	2/4	5/5	5/6	3/5		19 1 07	28 2 13
Karin Forseke <sup>b</sup>	2/3	0/0	1/1	2/2	1/1		1 12 04	3 7 12
John Griffith-Jones	6/6	2/2	2/3				1 9 12	31 3 13****
Mick McAteer <sup>b</sup>	10/10	3/4	6/6			5/5	1 11 09	31 3 13****
Brian Pomeroy <sup>a &amp; b</sup>	9/10	3/4	5/6		6/6	5/5	1 11 09	31 3 13****
Hector Sants	2/3	0/0					4 5 04	30 6 12
Andrew Scott <sup>b</sup>	10/10	1/4	6/6			5/5	1 11 09	31 3 13****
James Strachan <sup>b</sup>	8/10	2/4	5/6	7/7	4/6		1 11 09	31 3 13****
Paul Tucker <sup>b</sup>	6/10	0/4	4/6			2/5	1 3 09	31 3 13***
Adair Turner	10/10	4/4					20 9 08	31 3 13****
Martin Wheatley	10/10	3/4					1 9 11	31 3 13****

### Key

- a Chair of the FSA Pension Plan Trustee Ltd  
b Independent non-executive director

\* Additional to those scheduled at the start of the year

\*\* Considered to have recent and relevant experience for the purposes of the UK Corporate Governance Code

### Committee membership during the year:

#### Audit Committee (AuditCo)

Amanda Davidson \*\*  
Sandra Dawson  
Brian Flanagan  
Karin Forseke (Chair until 3 July 2012)  
Brian Pomeroy (Chair from 4 July 2012) \*\*  
James Strachan \*\*

\*\*\* The Financial Services & Markets Act 2000 required the Deputy Governor Financial Stability at the Bank of England to be a member of the Board of the FSA. In a reciprocal arrangement with the Bank of England, the FSA's Chairman served as a member of the Court of the Bank of England

\*\*\*\* Appointment terminated on 31 March 2013 when the FSA ceased to exist at legal cutover

#### Remuneration Committee (RemCo)

Amanda Davidson  
Sandra Dawson (Chair from 4 July 2012)  
Brian Flanagan  
Karin Forseke (Chair until 3 July 2012)  
James Strachan

The only members of the FSA were the directors. Each director undertook to guarantee the liability of the FSA up to an amount of £1

The executive directors were not directors of any UK-listed companies and had no other paid positions

#### Risk Committee (RiskCo)

Peter Fisher  
Mick McAteer  
Andrew Scott (Chair)  
Paul Tucker  
Brian Pomeroy

All the FSA's directors were appointed by the Treasury with input on the selection panel from at least one incumbent member of the FSA Board. Appointments were made in line with the principles in the code of practice issued by the Commissioner for Public Appointments

The Chairman of the FSA was appointed for a five-year term and all other directors were normally appointed for three-year terms. The executive directors had continuous employment contracts with the FSA, details of which are given in the Remuneration Report

#### Committee of Non-executive Directors (NedCo)

All non-executive directors were members of NedCo  
Karin Forseke was Chair until 3 July 2012  
Sandra Dawson was Chair from 4 July 2012

The directors present their report for the year ended 31 March 2013

## **Change of Company Name**

On 1 April 2013, following the enactment of section 1A of the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012), the name of the company was changed from The Financial Services Authority to The Financial Conduct Authority

## **Business review**

As a company, it is necessary for the FSA to provide a fair review of its business. This requirement is fulfilled by information provided in the first eight sections of the Annual Report

## **Principal activities**

During the year, the FSA was the primary regulator of financial services in the UK and had statutory responsibilities set out in the Financial Services and Markets Act 2000 (FSMA). Detailed information on its principal activities for the year can be found in sections one to eight of this Annual Report

## **Principal risks and uncertainties**

The principal risk for the FSA during the period under review was the failure to meet its statutory objectives

Due to the Government's regulatory reform proposals, there were considerable risks relating to the transition of the FSA's functions into the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA) and the Bank of England, including the impact on its capacity to deliver against its FSMA obligations. The Board regularly reviewed the executive's strategy to mitigate these risks, which was led by a high-level transition committee, and scrutinised and challenged the plan to ensure operational risks were minimised. All identified risks and uncertainties were kept under review throughout the organisation, including at the Executive Supervision and Risk Committee and at the highest level by the Risk Committee and the Audit Committee. Further information on some of the key areas recently reviewed can be found in the committees' reports

## **Development and performance of the FSA**

Analysis of the FSA's performance during the year and the position at the end of the financial year are set out in the Financial Review and the Financial Statements for the year

When the FCA came into existence at legal cutover on 1 April 2013, it was given a strategic objective under the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012) to ensure that the relevant markets function well. In addition, the FCA has three operational objectives: to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers

Further information on the FCA's objectives can be found in section one of this Annual Report and on the FCA's website

## **Qualifying indemnity provisions**

Qualifying third party indemnity provisions for the purposes of section 232 of the Companies Act 2006 were in force during the course of the financial year ended 31 March 2013 and remain in force at the date of this report

## **Directors' responsibilities in respect of the Annual Report and accounts**

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and estimates that are reasonable and prudent,
- state whether applicable International Financial Reporting Standards, as adopted by the European Union, have been followed, subject to any material departures disclosed and explained in the financial statements, and
- prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the company will continue in business

The directors are responsible for keeping proper accounting records that disclose, with reasonable accuracy at any time, the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and for taking reasonable steps to prevent and detect fraud and other irregularities.

As far as the directors are aware

- there is no relevant audit information of which the company's auditor is unaware, and
- the directors have taken all steps that they ought to have taken to make themselves aware of any relevant audit information and to establish that the auditor is aware of that information

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and distribution of financial statements may differ from legislation in other jurisdictions.

## **Financial position**

The primary source of income for the FSA was the fees charged to regulated firms. Specific information on its financial position is provided in the Financial Statements and in the Financial Review. The directors agree with the analysis in the Financial Review and believe the organisation is able to meet its liabilities as they fall due.

## **Going concern**

Throughout the period under review, the FSA was an independent body that regulated the financial services industry in the UK. Its powers and objectives were given to it by the Financial Services and Markets Act 2000 (FSMA). The business activities of the FSA during the last 12 months are summarised in the Executive Chairman's report. The Directors of the FCA (formerly the FSA) have considered the following risks and uncertainties in reaching a conclusion on going concern as set out below.

- 1 **Liquidity risk:** The FCA's strong fee covenants are underpinned by the statutory powers granted to it to raise fees to fund its regulatory activities. The FCA is also well placed from

a liquidity perspective, with £48 3m in cash reserves at 31 March 2013 and available and undrawn credit facilities of £115m

ii **Credit risk:** The FCA's credit risk falls into two main categories

- a the collection of fees from the financial services industry the organisation has a strong record in terms of collecting fees with bad debt experience averaging at less than 0.3% of fees receivable over the last three years, and
- b the placement of those fees as deposits with various counter-parties the FCA only invests with financial institutions that meet its minimum credit rating as assigned by credit rating agencies The FCA also spreads its deposits across a number of counter-parties to avoid the concentration of credit risk

iii **Critical Accounting Judgements and Key Sources of Estimation Uncertainty** that have been considered by the Directors are the estimated useful economic life of internally developed software and the assumptions underpinning the pension deficit as set out in Note 3 to the Financial Statements

Having regard to the above, it is the directors' opinion that the FCA is well placed to manage any possible future funding requirements pertaining to its regulatory activity and has sufficient resources to continue its business for the foreseeable future

The directors therefore conclude that using the going concern basis is appropriate as there are no material uncertainties related to events or conditions that may cast significant doubt about the FCA's ability to continue as a going concern

### **Corporate responsibility**

Throughout the year, the FSA played a key role in protecting and enhancing the integrity and stability of the UK financial system As such the FSA took its corporate citizenship seriously and led by example to influence positive change not only within the FSA but also among the financial services industry

To provide an effective and efficient regulatory service, it was important to ensure that the FSA could recruit, develop and retain a talented, engaged and diverse workforce To provide the best service to the public and to the financial sector, it needed to support staff to understand, represent and have close links with both the marketplace and the wider community In this way the organisation could be in the strongest position to fulfil its obligations and role

Within the FSA, Corporate Responsibility had three main objectives

- to make the FSA an employer of choice,
- to ensure it safeguarded all its resources, and
- to support staff to understand the communities the FSA served

#### *People*

The FSA was committed to promoting equality and diversity and creating a positive culture in all areas of its work as an employer and a regulator, where differences are recognised and supported Policies were in place outlining its approach to equality, diversity and inclusion, flexible working, career development and wellbeing Each of these emphasised the FSA's commitment to its people and key performance indicators focused on these areas Performance, where possible, was measured and reported in the corporate responsibility section of the FSA's website The FCA will continue to review and develop measures for those areas that are not currently assessed

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## *Environment*

The FSA was conscious of the impact of its operations on the environment and the increasing expectation that organisations should manage this impact. The organisation aimed to reduce CO<sub>2</sub> emissions, energy use, water and the waste it produced, as well as increase the amount of waste that was recycled. To achieve this it sought to raise awareness of environmental issues among its staff. Targets were set in each of its key impact areas, and these were measured and reported on in the corporate responsibility section of its website.

## *Community*

As well as an opportunity to engage within the wider community and have a positive impact, staff were encouraged to view volunteering as a tool to help them in their personal development. It was also seen as an opportunity to gain a better understanding of the community that would enhance the FSA's interactions with regulated firms leading to greater insights and improving the quality of regulatory policies and process.

## **Equality and diversity**

The FSA was committed to the principles of equality, diversity and inclusion and further information about its work in these areas is contained in Appendix 8 to this Annual Report.

## **Employee involvement**

A variety of media was used to communicate with employees, including the intranet, email, weekly floor briefings, forums, staff plenary sessions and staff meetings. Employees were invited to give feedback on the FSA and its operations both informally and formally, through a number of staff surveys.

The Staff Consultative Committee was the forum through which the FSA complied with the Information and Consultation of Employees Regulations 2004. It also provided a clear channel of communication and consultation between the FSA and its staff. It gave staff the opportunity to contribute to, and influence the development of, the FSA and to provide their views to the highest levels in the organisation. The Board and senior management recognised the importance and value of ensuring this process happened effectively.

## **Employee training**

Employees were given opportunities to undertake a variety of in-house and external training and, during the year, each employee spent an average of 5.8 days training (2011/12: 6.29 days).

## **Charitable donations**

The FSA did not make any charitable donations during the year (2011/12: Nil).

## **Health and safety**

The FSA remained committed to providing a healthy and safe environment. A policy to promote health and safety at work was pursued and the cooperation of all employees and visitors was sought in this endeavour.

## **Creditor payment policy**

The FSA's policy was to aim to pay 90% of valid invoices with a correct purchase order within 30 days of receiving them. During the year, 92.8% of invoices were paid within the service standard.

(2011/12 91.7%). The average time taken to pay suppliers from receipt of invoice was 27 days (2011/12 24 days).

**Auditor**

The National Audit Office was appointed as the auditor of the company at a General Meeting on 1 July 2010 and was the auditor throughout the 2012/13 financial year

By Order of the Board

A handwritten signature in black ink, appearing to read 'S Pearce', with a long horizontal flourish extending to the right.

S Pearce  
Secretary  
13 June 2013

## **CORPORATE GOVERNANCE STATEMENT FOR THE YEAR ENDED 31 MARCH 2013**

The FSA was a company limited by guarantee and was therefore not obliged to comply with the UK Corporate Governance Code (the Code). However, FSMA required the organisation to have regard to generally accepted principles of good corporate governance as applicable. The Board was committed to meeting high standards of corporate governance and decided to comply with the Code as far as appropriate. This report sets out how the FSA was governed in line with the Code's principles.

FSMA required the FSA to have a number of accountability mechanisms, including an Annual Public Meeting and to report on the extent to which its regulatory objectives were met. The FSA was funded by the industry it regulated through its statutory fee-raising powers and it operated independently of Government, but was accountable to Parliament through obligations set out in FSMA. Consultation with consumers and practitioners on rules and general policy was undertaken through the Consumer, Practitioner and Smaller Businesses Practitioner Panels.

The FSA was led by a Board, which developed its strategy and approved and monitored the annual operating plan and budget. Certain responsibilities were reserved to the Board for its decision and these were set out in the schedule of matters reserved to the Board. There was also a governance memorandum detailing the functions that had been delegated by the Board. The majority of the FSA Board comprised non-executive directors who, in addition to their statutory responsibilities under the Companies Act 2006, had specific obligations under FSMA. The Board was of sufficient size to ensure that the requirements of the business could be met and that changes to the Board composition and any of its committees could be managed without undue disruption. FSMA required that there was a non-executive directors' committee (NedCo), which kept certain functions under review. Information on NedCo's work is set out in the non-executive directors' report.

The Board and Board Committees met regularly during the year and details of the number of meetings held and attendance at those meetings are set out in Table 1. The membership of the various committees can also be found in Table 1.

Before Hector Sants resigned as chief executive with effect from 30 June 2012, the roles of the FSA chair and chief executive were separate: the chair, who was independent on appointment in September 2008, led the Board and ensured its effectiveness, and the chief executive was responsible for developing and delivering the strategic objectives agreed with the Board. Between Mr Sants' resignation and legal cutover to the new regulatory system on 1 April 2013, Adair Turner acted as executive chairman.

In preparation for legal cutover, the FSA operated an internal 'twin peaks' structure during the year, with a Conduct Business Unit led by Martin Wheatley and a Prudential Business Unit led by Andrew Bailey.

The non-executive directors of the Board had a variety of appropriate skills and experience. Apart from any contact they may have had with the FSA as a result of being connected with a regulated firm, or as consumers of regulated products, the non-executive directors were judged by the Board to be independent of the FSA. Where any conflicts of interest arose relating to personal or business matters, procedures were in place to ensure that no director would be exposed and that decisions would be made without undue influence.

The chair ensured, with the company secretary, that the Board's agendas were set in line with the priorities of the organisation. The company secretary reviewed papers before their circulation to Board members to ensure that information was accurate and clear. Papers for Board and Committee meetings were usually circulated one week before meetings.



Until legal cutover, one of the non-executive directors acted as chair of the non-executive directors' committee and was viewed as the senior independent director. The non-executive directors' committee ceased to exist in the new regulatory framework

Directors of the FSA were formally appointed by the Treasury following a rigorous selection process. The selection panel comprised representatives of both the FSA and the Treasury and the procedures followed were in line with the principles in the code of practice issued by the Office of the Commissioner for Public Appointments

The company secretary arranged induction for new directors that was appropriate for their knowledge and experience. The Board also received ongoing professional development on relevant issues. During the last year this included training for non-executive directors on consumer credit and platforms. Individual directors have also had personal briefings on other topics, such as interest-only mortgages, before Board meetings

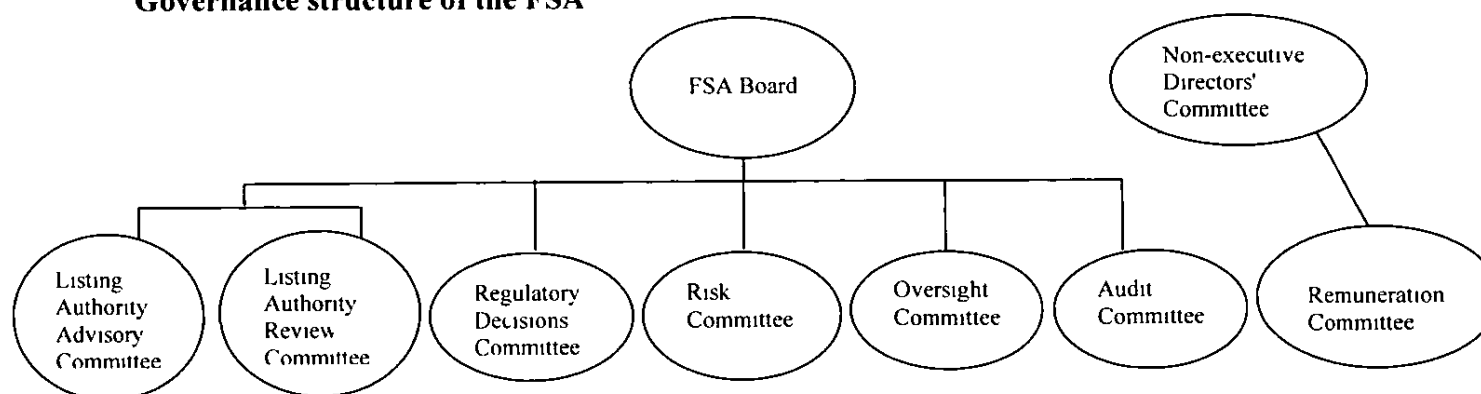
Each director had access to the advice and services of the company secretary, who also advised the Board on all aspects of governance matters. The company secretary was responsible for providing access to external professional advice for directors, if required

Due to its statutory nature, the FSA benefited from immunity under FSMA in respect of legal action, which it supplemented with indemnities in favour of individual directors. The Board therefore regarded insurance in respect of legal action against directors as unnecessary

As reported last year, a number of evaluations relating to the Board, its members and committees that were started during 2011/12, were completed in the early part of 2012/13. These were facilitated by external consultants and reviewed what lessons could be learned for the remaining tenure of the FSA and for the future operation of the FCA. In view of the changes to the regulatory framework and the transition of the FSA into two new regulatory bodies, it was agreed that it would not be appropriate to carry out further reviews of the effectiveness of the Board, its members or its committees during 2012/13.

In September 2011, the Board established a sub-group to support the executive in the development of the FCA. The sub-group was initially chaired by Adair Turner as chair of the FSA and, from October 2012, by John Griffith-Jones as chair-designate of the FCA. The other members of the sub-group were all non-executive directors. The sub-group was advisory in nature and had no delegated decision-making duties or powers. It was responsible for providing support and challenge to the CEO designate of the FCA to ensure the FCA was developed as a 'fit for purpose' successor to the FSA

### Governance structure of the FSA



In October 2012 the Board also established a sub-committee to oversee the FSA's review of the failure of HBOS

## **The non-executive directors' committee (NedCo)**

The functions of NedCo were set out in the provisions of Schedule 1 to FSMA and, during the year, NedCo ensured that its statutory functions were being satisfactorily discharged by

- reviewing reports on the efficient and economic use of the FSA's resources,
- receiving reports on the Audit Committee's (AuditCo) work in keeping under review the question of whether the internal financial controls secured the proper conduct of the FSA's financial affairs (via reports made to the Board), and
- receiving reports from the Remuneration Committee (RemCo) on the remuneration awards to the executive directors and the chairman, and the performance-related bonus payments made to the executive directors

NedCo's composition is shown in Table 1

### **Report of the non-executive directors**

The Board was the FSA's primary decision-making body. It also exercised a broad oversight of all policy, strategic and operational activities. The extent of the Board's role and the information provided to it, allowed NedCo to rely largely on the Board's work while sharing other functions, including oversight of internal controls, with AuditCo. RemCo reported on its work to NedCo.

#### *Efficiency and economy*

During the year, NedCo reviewed whether the FSA was using its resources in the most efficient and economic way. Data relating to measuring efficiency and economy formed part of the management information presented to the Board quarterly, and was reviewed specifically by NedCo. NedCo challenged the information it received and sought further explanations when appropriate. During the year under review, NedCo monitored the implementation of the internal twin peaks system, which separated the FSA's business into prudential and conduct divisions in preparation for legal cutover to the new regulatory framework on 1 April 2013. One impact of internal twin peaks within the Conduct Business Unit was an initial shortage of experience of managers with their firms due to the split of staff following the introduction of the internal twin peaks structure and the previous focus on prudential issues. NedCo noted, however, that this was being addressed through training to ensure that staff were appropriately skilled.

#### *Internal financial controls*

During the year, AuditCo reviewed audit progress reports from the National Audit Office and assessments from the Internal Audit Division on the relevant FSA key internal controls to obtain assurance that the internal financial controls secured the proper conduct of the organisation's financial affairs. Feedback on this work was provided to the Board. The full statement on internal controls, which includes information on financial controls is on page 89.

#### *Remuneration of the executive directors*

NedCo had delegated to RemCo the function of determining the remuneration of the chair, the chief executive, the executive directors and certain other senior staff.

In addition to its statutory functions, NedCo discussed how the Board was involved in, and alerted to, issues of significant interest or issues that had significant reputational impact. This assisted in considering the design for the FCA governance structure to ensure that processes were in place to facilitate the most effective communication.

## Remuneration report

This section of the remuneration report is not subject to audit

### *Remuneration Committee (RemCo)*

RemCo was a committee of NedCo and was chaired by the chair of NedCo

During the year, RemCo met formally on seven occasions, and some decisions were initially made by email and later ratified

### *Remuneration strategy*

The FSA's remuneration strategy was to provide a remuneration package that.

- helped to attract, retain and motivate staff,
- recognised its role and responsibilities as a public authority,
- was as competitive as possible against the appropriate market,
- encouraged and supported a culture aligned to achieving its statutory objectives,
- was fair and transparent, and
- was capable of being applied consistently across the organisation

### *Remuneration policy*

To achieve the remuneration strategy, the remuneration policy aimed to

- set base salaries at, or around, the median of the relevant market competitive level,
- target reward at those whose performance was strongest,
- reward stretching performance; and
- provide an appropriate balance between the need to attract, retain and motivate staff, while reflecting the constraints placed on a public authority

### *2012/13 Remuneration review*

The total remuneration package, which was common to all FSA employees, comprised

- basic pensionable salary,
- eligibility to be considered for a performance-related annual individual incentive award,
- additional flexible benefits, and
- pension contribution

Information on the appointment of the chair of the FSA and its executive directors can be found in the Directors' Report and in Table 1. The information contained in the remuneration table has been audited by the external auditor. All individuals who held the post of executive director during the year had continuous contracts of employment providing for no more than 12 months' prior notice of termination by either party. The chair was employed on a fixed-term contract, which began on 20 September 2008 and was due to end on 19 September 2013, although, as noted elsewhere in this Annual Report, Adair Turner stepped down as chair and as a director of the organisation when the FSA ceased to exist at legal cutover.

RemCo determined the remuneration of the executive directors. To help with this, RemCo received information on, and assessment of, their individual performance. Performance was measured against

the achievement of the collective FSMA objectives by reference to the Business Plan, the objectives relating to the directors' individual areas of responsibility and assessment of their leadership abilities

In considering executive remuneration, RemCo had advice from the Director of Human Resources and market data from Towers Watson, its external consultants

- **Basic pensionable salary**

Salaries were reviewed annually in line with the policy. When making decisions on base salary, RemCo was mindful of the need for public sector organisations to continue to exercise restraint

In considering the pay review for the year, the committee noted the importance of remuneration packages being sufficient to attract and retain staff while awarding any salary increases in a responsible manner, ensuring careful use of the FSA's resources. Some difficulties were experienced in attracting and retaining certain levels of suitably qualified professionals and, to retain the appropriate staff, it was important for the Executive to focus reward clearly on performance. This resulted in some staff receiving no pay increase, but the committee considered that the previous year's exercise, which had aimed to give the majority of staff a pay rise and also to address key anomalies, went some way to ameliorating this issue.

The Committee noted that the Executive had issued new equal pay guidelines and required clear indications of peer comparisons for all staff. The FCA Executive will look at the design of the pay bands for the new organisation and the need to ensure reward is linked to performance will continue to be emphasised.

- **Annual incentive award**

During the period under review, the executive directors were eligible to be considered for a performance-related incentive award up to a maximum of 35% of average base pensionable salary applying during the previous year.

Last year, the organisation had an extended performance period of 15 months (1 January 2011 – 31 March 2012) to enable the performance period to align with the financial year. This was a one off transition. For 2012/13, the performance year was 1 April 2012 – 31 March 2013.

Please note that the incentives for 2011/12, which are shown in the remuneration table on page 85 for comparison purposes, are for the 15-month period from 1 January 2011 to 31 March 2012.

The chair was not eligible to be considered for an individual incentive award. When making its decisions, RemCo took proper account of all aspects of the FSA's and the individual's performance.

- **Other benefits**

A sum was available for each director, which could be spent against a range of benefits. The sum for the chair and executive directors is included in 'other emoluments' in the remuneration table. The chair and executive directors also had access to a car and driver and, where appropriate, the relevant portion of these costs is included in 'other emoluments' in the remuneration table.

- **Pensions**

The FSA Pension Plan (the Plan) has two sections, both of which are non-contributory, a defined benefits section (closed to new entrants and any future accruals) and a defined contribution section. Adair Turner and Hector Sants are not members of the Plan and were entitled to receive a non-pensionable supplement. The sums paid to the chair and each of the executive directors, in respect of each component, are shown in the remuneration table.

## Remuneration Table

	Board fee £	Salary £	Performance related bonus £	Other emoluments and benefits £	Contractual Entitlements on Termination £	Pension £	2013 Total £	2012 Total £
<b>Chairman</b>								
Adair Turner <sup>1 2 4</sup>	-	446,250	-	33,353	252,000	53,550	785,153	500,474
<b>Executive Directors</b>								
Hector Sants <sup>2 11</sup>	-	184,615	-	30,648	300,178	15,000	530,441	835,731
Martin Wheatley <sup>2 9</sup>	-	429,999	86,000	112,386	-	38,700	667,085	399,657
<b>Non-executive Directors <sup>5</sup></b>								
Amanda Davidson	35,000	-	-	-	-	-	35,000	35,000
Sandra Dawson <sup>6, 13</sup>	42,436	-	-	-	-	-	42,437	35,000
Peter Fisher <sup>7 13</sup>	-	-	-	-	-	-	-	-
Brian Flanagan <sup>12</sup>	32,083	-	-	-	-	-	32,083	35,000
Karin Forseke <sup>10</sup>	15,462	-	-	-	-	-	15,462	57,333
John Griffith-Jones <sup>2, 3</sup>	99,167	-	-	192	-	11,900	111,259	-
Mick McAteer	35,000	-	-	-	-	-	35,000	35,000
Brian Pomeroy <sup>6 8</sup>	62,436	-	-	-	-	-	62,436	55,000
Andrew Scott <sup>6 13</sup>	45,000	-	-	-	-	-	45,000	37,012
James Strachan <sup>13</sup>	35,000	-	-	-	-	-	35,000	35,000
Paul Tucker <sup>7 13</sup>	-	-	-	-	-	-	-	-
	401,584	1,060,864	86,000	176, 579	552,178	119,150	2,396,356	2,060,207
Remuneration as executives							1,982,679	1,735,862
Fees for service as Directors							413,677	324,345
							2,396,356	2,060,207

**Where Directors have served for part of the year only, the remuneration figures are shown as pro-rated**

- 1 On becoming Executive Chairman with effect from 1 July 2012, Adair Turner's salary was increased to £450,000 from £435,000
- 2 Adair Turner, Hector Sants, Martin Wheatley and John Griffith-Jones are not members of the FSA Pension Plan and received a non pensionable supplement in lieu of pension contributions
- 3 John Griffith-Jones was appointed as a non-executive director and chairman designate of the FCA on 1 September 2012
- 4 The total emoluments of the highest paid director during the year, Adair Turner, were £785,153 (2011/12 £500,474) This included £252,000 paid as compensation on termination of his employment on 31 March 2013, as he was restricted in respect of taking paid employment for a period of six months Lord Turner had been employed on a fixed-term contract which was due to end on 19 September 2013
- 5 The fee for non-executive directors was set by the independent panel, established with the approval of HMT, at £35,000 per annum with effect from 1 April 2011 This remained unchanged in 2012/13
- 6 An additional fee of £10,000 per annum is paid to any non-executive director who has been appointed to chair a committee of the Board Andrew Scott was appointed to chair the Risk Committee from 19 January 2012 Brian Pomeroy was appointed as Audit Committee Chair with effect from 4 July 2012 Sandra Dawson was appointed as Chair of NedCo with effect from 4 July 2012
- 7 Peter Fisher and Paul Tucker both waived their Board fee in respect of the years concerned
- 8 Brian Pomeroy was appointed to chair the FSA Pension Plan Trustee Ltd from 1 June 2010 The annual fee was set by the independent panel at £20,000 with effect from 1 April 2008 This remained unchanged in 2012/13
- 9 Martin Wheatley was appointed as an executive director from 1 September 2011 and accordingly his remuneration for 2012 in the table above is only in respect of seven months
- 10 Karin Forseke discharged the role of Chair of Nedco and Senior Independent Director from June 2010 until her resignation from the board with effect from 3 July 2012 She undertook additional work in relation to this and her appointment as Deputy Chair was formalised with effect from 1 June 2011 There was an adjustment to her fees to reflect the additional work to a total of £60,000 which comprised a Non-executive director fee of £35,000, an additional fee for chairing AuditCo of £10,000, and an uplift as Deputy Chair of £15,000 The maximum amount for this position had previously been set by the independent panel at £69,000
- 11 Hector Sants resigned as chief executive and as a director with effect from 30 June 2012 In line with his contractual entitlement, on leaving the FSA he continued to be employed by the FSA for a further six months during which he received his full pay and benefits and was unable to take paid employment in another organisation
- 12 Brian Flanagan resigned as a director with effect from 28 February 2013
- 13 Sandra Dawson, Peter Fisher, Andrew Scott and James Strachan resigned as directors with effect from 31 March 2013 and Paul Tucker also left the board with effect from 31 March 2013 when section 1A of the Financial Services and Markets Act 2000 took effect
- 14 Margaret Cole resigned as a director with effect from 31 March 2012 In line with her contractual entitlement, on leaving the FSA she continued to be employed by the FSA for a further five months during which she received her full pay and benefits totalling £250,897 and was unable to take paid employment in another organisation

### **Non-executive directors**

It was not considered appropriate for the fees payable to the FSA's non-executive directors to be increased in the last year before the regulatory restructure and accordingly the level of fees remained unchanged during 2012/13

The fees payable are shown in the notes to the remuneration table

### **Committees of the Board**

#### **Audit Committee (AuditCo)**

AuditCo's purpose within the FSA was to be responsible for reviewing and providing assurance to the Board on the effectiveness of the FSA's internal controls and risk management systems, the integrity in the annual accounts of the financial statements that relate to financial controls and internal risk, and oversight of the external audit process The review of external risks and the review of individual firms were outside the Committee's terms of reference The former lay with RiskCo and the latter with the supervisory process

Details of AuditCo members' attendance at meetings can be found in Table 1

In view of the changes to the regulatory framework and the transition of the FSA into two new regulatory bodies, it was agreed that it would not be appropriate to carry out a further review of the committee's effectiveness in the 2012/13 financial year The operation of AuditCo was, however, reviewed with respect to the way it will operate following legal cutover and the committee's terms of reference have been amended as appropriate

AuditCo met on six occasions during the year, in addition to the four scheduled meetings, the committee also formally met twice to consider progress on the review being undertaken by Internal Audit in relation to LIBOR The FSA Chief Executive attended one of the scheduled meetings before leaving the organisation and the FCA Chief Executive designate attended three of the scheduled

meetings. The chief operating officer, the director of internal audit and the lead audit partner from the National Audit Office (NAO) or his alternate, attended each of the scheduled meetings at the request of the committee chair. Private sessions were held with the internal and external auditors during the year without management present. The committee also held private sessions with a number of members of the senior leadership team without management present.

The committee reviewed and challenged the risk reporting proposals under the twin peaks model and expressed concern that operational problems could arise as a result of a vacuum during the transition process. Following discussion with the chief executive, however, the committee considered that the proposed way forward was sensible, but expressed concern that an FSA consolidated risk report was not available between the introduction of ITP and legal cutover.

The committee also oversaw the review by Internal Audit of the extent of awareness within the FSA of inappropriate LIBOR submissions.

To discharge its functions AuditCo carried out the following during 2012/13:

- Monitored the integrity of the financial statements and challenged management on financial performance
- Reviewed the financial reporting judgments and disclosure issues
- Reviewed pension plan arrangements
- Reviewed the FSA's financial policies.
- Reviewed the chairman's expenses
- Reviewed and challenged the identification of internal risks, including financial management risks, information systems risk and people risks (as reflected in the consolidated risk report), and managers' mitigation of these risks
- Reviewed the operation of the FSA's whistleblowing policy and received reports on specific issues
- Reviewed compliance by FSA staff with key internal policies and procedures, including the operation and management of the Staff Code of Conduct
- Reviewed potential and actual litigation against the FSA
- Reviewed the audit universe (i.e. the internal audit framework) and approved proposals by Internal Audit for it to be more risk-focused
- Reviewed and approved the audit plans for internal audit
- Monitored and challenged managers on their responsiveness to internal audit findings
- Reviewed the quarterly reports from internal audit
- Reviewed the independence and effectiveness of the external auditor. The FSA aimed to protect the external auditor's independence through its policy, which required that fees for non-audit services were limited to the charge for performing the audit of its annual accounts. Information on fees paid to the auditor is given on page 113. Moreover, there were no relationships between the NAO or its staff and the FSA that affected the NAO's objectivity and independence
- Considered the external auditor's audit strategy for the financial year
- Reviewed programme and project management in the FSA
- During the year the Audit Committee also commissioned a review of the adequacy and effectiveness of the Internal Audit function. This work was carried out by an external consultant who was specifically asked to ensure that the outputs from the review would be as useful as possible, both for the FSA and for the FCA in the new regulatory structure. The outcome of the review was very positive, noting that the Internal Audit function had strong leadership, a

professional team and good execution of work. The report also made a number of recommendations meriting further consideration by the FCA Audit Committee and the FCA executive in due course.

### **Risk Committee (RiskCo)**

RiskCo's purpose was to help the Board review external risks to its statutory objectives. It did not review internal risks, which were the responsibility of AuditCo, nor did it review individual firms.

Details of RiskCo members' attendance at meetings can be found in Table 1.

As the FSA would cease to exist following legal cutover, it was agreed that it would not be appropriate to carry out a further review of the committee's effectiveness in the 2012/13 financial year. The operation of RiskCo was, however, reviewed with respect to the way it will operate in the FCA following legal cutover and the committee's terms of reference have been amended to reflect its proposed purpose and duties as the FCA risk committee in the new regulatory framework.

RiskCo had responsibility for review and oversight of the risks to the FSA's statutory objectives, the FSA executive's appetite for such risks, and the management and mitigation strategies and systems used to control these risks. In discharging that responsibility, RiskCo received regularly during the year, information on the top risks as articulated by both the CBU and PBU Executives. These risks were reviewed by the Executives in the respective business units, who considered appropriate mitigation strategies.

The committee sought assurance from the FSA Executive through debate and challenge in the following areas: whether the major risks to the FSA's statutory objectives and its reputation had been identified and prioritised appropriately, whether the actions taken to address and mitigate the risks were effective, and whether the timescales for mitigation were appropriate. RiskCo reported to the Board on its consideration of the risk areas and reports from the Executive.

During the year, RiskCo highlighted to the Board concerns that the move to an Internal Twin Peaks (ITP) model had led to some elements of the control framework being weakened. In particular, a separation of the way in which the FSA's risk framework was being applied in the prudential and conduct business units. On balance, RiskCo believed this development of separate risk tolerances and frameworks in the new regulators, continued macroeconomic strains and the extent of internal change to the organisation elevated substantially risks to the FSA's statutory objectives, although not necessarily to its successor organisations. RiskCo requested that the Executive of both the Conduct Business Unit and the Prudential Business Unit keep it informed of their developing new frameworks and that it be kept fully informed of issues emerging under these frameworks.

RiskCo discussed with management the amount and detail of the information provided to it, as this had reduced following the introduction of ITP. For part of the year, RiskCo considered that it did not have enough information about new approaches being used to effectively challenge the Executive or to provide assurance to the Board that risks were being measured or mitigated appropriately. When additional information was requested and provided by the Executive on the top down and bottom up risks, this provided reassurance that key risks had been identified even if mitigation was difficult during the period of change and transition to the new regulatory structure.

Being conscious of the risks of transition from the FSA to the FCA, RiskCo kept under review the coordination between the prudential and conduct business units of the FSA. The committee also considered a number of forward-looking risk scenarios and a diverse range of risks and mitigation strategies, including consideration of the FCA risk outlook, the development of the FCA's approach to risk and business model and strategy analysis as a tool to identify potential conduct issues.



## **Internal controls**

The Board and NedCo (the latter under FSMA) were responsible for ensuring the FSA had a sound system of internal controls and risk management (internal risks being overseen by AuditCo and external regulatory risks by RiskCo) AuditCo reported at least quarterly to the Board on internal controls and internal risk management AuditCo received regular reports from managers on financial, operational and compliance controls and the risk management systems In addition it received and reviewed reports from the Director, Internal Audit summarising work undertaken, findings and actions by managers

The system was designed to provide reasonable but not absolute assurance against material misstatement or loss and to manage rather than eliminate risks to the FSA's statutory objectives The Board's policy on internal controls and risk management included established processes and procedures for identifying, evaluating and managing significant risks

The internal control processes were in place throughout the year

Key features of the internal control system included the following

- Risk reporting that highlighted the key internal and regulatory risks faced This facilitated discussion on the best course of action to mitigate the key risks and helped senior managers make decisions on priorities and resource allocation This was regularly reviewed by the Executive Operations Committee and the Executive Committee and formally reported to AuditCo on a quarterly basis through the consolidated risk report
- A review of the framework of controls to mitigate the key internal (and regulatory) risks faced
- Internal Audit's provision of independent assurance to the FSA Board and management on the effectiveness of risk management and controls over all of our activities
- The Audit Universe, which contained all our activities, systems, projects and programmes Each unit within the universe was assessed appropriately to prioritise review by Internal Audit and these priorities were revised periodically Factors considered included risk, business criticality and materiality
- The terms of reference of the Internal Audit function were reviewed during the year As noted in AuditCo's report, a full review of the effectiveness of Internal Audit was also carried out during the year
- Clear reporting lines and delegated authorities, which were reviewed on a regular basis
- The external audit, including interim and final audit, which provided assurance to the Board and senior management in relation to financial controls The independence and effectiveness of the external auditor was reviewed by AuditCo and reported to the Board on an annual basis
- Clear segregation of the regulatory aspects of the FSA's supervisory operations and those of the internal treasury function In addition a third party was used to decide, from a list of approved counterparties, where best to place deposits for the optimum return This enabled the FSA to adopt a robust 'Chinese Wall' arrangement in line with good market practice
- Ensuring appropriate policies and procedures were contained within the staff handbook
- The performance management framework, which included setting objectives on an annual basis and a formal appraisal process
- Directors' and senior managers' commitment to maintaining an appropriate control culture across the FSA, which was regularly communicated to all staff

## **Regulatory Decisions Committee (RDC)**

The RDC decides whether the regulator should give the statutory and other notices described as within its scope by the Handbook, any regulatory guide or legislation During the period under review,

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members of the RDC were appointed by the FSA Board. The FSA Board received quarterly reports from the RDC Chairman, who also attended Board meetings twice a year to discuss significant matters in those reports

### **Listing Authority Committees**

The Listing Authority Advisory Committee (LAAC), the membership of which comprises external practitioners, met three times during the year. LAAC's role was to advise the Board and review elements of the FSA's function as the competent authority for listing in the UK. The chairman provided reports to the Board on relevant issues

The Listing Authority Review Committee, whose role within the FSA was as a technical appeal committee, was not called during the year

## **The Financial Services Authority**

### **Financial statements for the period ended 31 March 2013**

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## **Independent Auditor's Report to the members of the Financial Services Authority**

I have audited the financial statements of the Financial Services Authority for the period ended 31 March 2013 which comprise the Statement of Comprehensive Income, Statement of Changes in Equity, Statement of Financial Position, Statement of Cashflows and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the European Union. I have also audited the information in the Remuneration Report that is described in that report as having been audited.

### **Respective responsibilities of the directors and the auditor**

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### **Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements. In addition I read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

### **Opinion on financial statements**

In my opinion

- the financial statements give a true and fair view of the state of the company's affairs as at 31 March 2013 and of its surplus for the period then ended, and

- the financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by European Union, and
- the financial statements have been prepared in accordance with the Companies Act 2006

#### **Opinion on other matters prescribed by the Companies Act 2006**

In my opinion

- the information given in the Directors' Report for the financial period for which the financial statements are prepared is consistent with the financial statements, and
- the part of the directors' remuneration report described as having been audited, has been prepared in accordance with the requirements of the Companies Act 2006, that would have applied if the FSA were a United Kingdom incorporated quoted company

#### **Matters on which I report by exception**

I have nothing to report in respect of the following matters where the Companies Act 2006 requires me to report to you if, in my opinion

- adequate accounting records have not been kept, or
- the financial statements or the part of the directors' remuneration report that is described as having been audited are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- I have not received all of the information and explanations I require for my audit



24 June 2013

**Bryan Ingleby (Senior Statutory Auditor)**

For and on behalf of the **Comptroller and Auditor General (Statutory Auditor)**

National Audit Office

157-197 Buckingham Palace Road

London SW1W 9SP

## Statement of comprehensive income for the period ended 31 March

	Notes	Continuing operations 2013 £m	Operations to be transferred 2013 <sup>1</sup> £m	Total 2013 £m	Continuing operations 2012 £m	Operations to be transferred 2012 <sup>1</sup> £m	Total 2012 £m
Administrative costs		(395.5)	(187.6)	(583.1)	(340.3)	(185.8)	(526.1)
Interest on bank deposits	18	1.7	-	1.7	1.8	-	1.8
Other net finance costs	14	(5.0)	-	(5.0)	(4.2)	-	(4.2)
Profit on disposal	5	-	-	-	12.8	-	12.8
Other income	7	16.7	22.6	39.3	21.9	23.8	45.7
<b>Net costs for year</b>		<b>(382.1)</b>	<b>(165.0)</b>	<b>(547.1)</b>	<b>(308.0)</b>	<b>(162.0)</b>	<b>(470.0)</b>
Fee income		400.4	167.6	568.0	338.7	167.2	505.9
<b>Surplus before taxation</b>	5	<b>18.3</b>	<b>2.6</b>	<b>20.9</b>	<b>30.7</b>	<b>5.2</b>	<b>35.9</b>
Taxation	8	1.8	-	1.8	(0.4)	-	(0.4)
<b>Surplus after taxation</b>		<b>20.1</b>	<b>2.6</b>	<b>22.7</b>	<b>30.3</b>	<b>5.2</b>	<b>35.5</b>
Net actuarial losses for the year in respect of the defined benefit pension scheme	14	(43.9)	-	(43.9)	(7.9)	-	(7.9)
<b>Total comprehensive (loss)/ income for the year</b>		<b>(23.8)</b>	<b>2.6</b>	<b>(21.2)</b>	<b>22.4</b>	<b>5.2</b>	<b>27.6</b>

<sup>1</sup> - Operations to be transferred relate to the Prudential Business Unit and other operations that are transferring to the Prudential Regulation Authority (PRA) and the Bank of England (BoE) on 1 April 2013

## Statement of changes in equity for the period ended 31 March 2013

	£m
<b>At 1 April 2011</b>	<b>(93.7)</b>
Total comprehensive income for the year	27 6
<b>At 31 March 2012</b>	<b>(66.1)</b>
Total comprehensive loss for the year	(21 2)
<b>At 31 March 2013</b>	<b>(87.3)</b>

# Statement of financial position as at 31 March 2013

Company Number: 1920623

	Notes	Continuing operations 2013 £m	Assets and liabilities to be transferred 2013 <sup>1</sup> £m	Total 2013 £m
<b>Non-current assets</b>				
Intangible assets	9	79.1	15.0	94.1
Property, plant and equipment	10	45.8	3.0	48.8
		<b>124.9</b>	<b>18.0</b>	<b>142.9</b>
<b>Current assets</b>				
Trade and other receivables	11	67.3	1.1	68.4
Cash and cash equivalents	11	392.0	-	392.0
Current tax asset	11	2.1	-	2.1
		<b>461.4</b>	<b>1.1</b>	<b>462.5</b>
<b>Total assets</b>		<b>586.3</b>	<b>19.1</b>	<b>605.4</b>
<b>Current liabilities</b>				
Trade and other payables	12	(543.7)	(21.7)	(565.4)
Current tax liabilities	12	-	-	-
Borrowings	12	-	-	-
		<b>(543.7)</b>	<b>(21.7)</b>	<b>(565.4)</b>
<b>Total assets less current liabilities</b>		<b>42.6</b>	<b>(2.6)</b>	<b>40.0</b>
<b>Non-current liabilities</b>				
Trade and other payables	12	(12.6)	-	(12.6)
<b>Net assets excluding retirement benefit obligation</b>		<b>30.0</b>	<b>(2.6)</b>	<b>27.4</b>
Retirement benefit obligation	14	(114.7)	-	(114.7)
<b>Net liabilities, including retirement benefit obligation</b>		<b>(84.7)</b>	<b>(2.6)</b>	<b>(87.3)</b>
<b>Accumulated deficit</b>		<b>(84.7)</b>	<b>(2.6)</b>	<b>(87.3)</b>

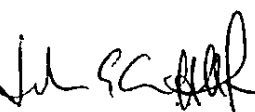
<sup>1</sup> – Assets and liabilities to be transferred relate to the Prudential Business Unit and other operations that are transferring to the PRA and the BoE on 1 April 2013



	Notes	Continuing operations 2012 £m	Assets and liabilities to be transferred 2012 <sup>1</sup> £m	Total 2012 £m
<b>Non-current assets</b>				
Intangible assets	9	84.9	11.2	96.1
Property, plant and equipment	10	57.0	3.5	60.5
		<b>141.9</b>	<b>14.7</b>	<b>156.6</b>
<b>Current assets</b>				
Trade and other receivables	11	30.3	0.6	30.9
Cash and cash equivalents	11	72.0	-	72.0
Current tax asset	11	-	-	-
		<b>102.3</b>	<b>0.6</b>	<b>102.9</b>
<b>Total assets</b>		<b>244.2</b>	<b>15.3</b>	<b>259.5</b>
<b>Current liabilities</b>				
Trade and other payables	12	(181.5)	(18.6)	(200.1)
Current tax liabilities	12	(0.2)	-	(0.2)
Borrowings	12	(1.2)	-	(1.2)
		<b>(182.9)</b>	<b>(18.6)</b>	<b>(201.5)</b>
<b>Total assets less current liabilities</b>		<b>61.3</b>	<b>(3.3)</b>	<b>58.0</b>
<b>Non-current liabilities</b>				
Trade and other payables	12	(17.0)	-	(17.0)
<b>Net assets excluding retirement benefit obligation</b>		<b>44.3</b>	<b>(3.3)</b>	<b>41.0</b>
Retirement benefit obligation	14	(107.1)	-	(107.1)
<b>Net liabilities including retirement benefit obligation</b>		<b>(62.8)</b>	<b>(3.3)</b>	<b>(66.1)</b>
<b>Accumulated deficit</b>		<b>(62.8)</b>	<b>(3.3)</b>	<b>(66.1)</b>

<sup>1</sup> – Assets and liabilities to be transferred relate to the Prudential Business Unit and other operations that are transferring to the PRA and the BoE on 1 April 2013

The financial statements were approved and authorised for issue by the Board on 3 June 2013, and were signed on its behalf by

John Griffith-Jones  Chairman

Martin Wheatley  Chief Executive Officer

## Statement of cash flows for the period ended 31 March 2013

	Notes	2013 £m	Restated <sup>1</sup> 2012 £m
<b>Net cash generated from operations</b>	18	<b>358.0</b>	<b>(4.7)</b>
Corporation tax received/(paid)	8	1 8	(0 4)
<b>Net cash from operating activities</b>		<b>359.8</b>	<b>(5.1)</b>
<b>Investing activities</b>			
Interest received on bank deposits		1 7	1 8
Expenditure on software development	9	(29 1)	(28 1)
Purchases of property, plant and equipment	10	(11 2)	(12 9)
Proceeds from sale of asset		-	15 0
<b>Net cash used in investing activities</b>		<b>(38.6)</b>	<b>(24.2)</b>
<b>Returns on investment and servicing of finance</b>			
(Repayments)/proceeds from borrowings		(1 2)	1 2
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>320.0</b>	<b>(28.1)</b>
<b>Cash and cash equivalents at the start of the year</b>		<b>72 0</b>	<b>100 1</b>
<b>Cash and cash equivalents at the end of the year</b>		<b>392.0</b>	<b>72.0</b>

<sup>1</sup> Restated – The prior year figures have been restated to reflect a correction to the proceeds from borrowing figure

# Notes to the financial statements – 31 March 2013

## 1. General information

The Financial Services Authority Limited (FSA) is a company incorporated in the United Kingdom under the Companies Act 2006 and is a company limited by guarantee with no share capital. The members of the company have agreed to contribute £1 each to the assets of the company in the event of it being wound up. The nature of the FSA's operations and its principal activities are set out in the Directors' Report.

As part of the Financial Services Act 2012, the Prudential Regulation Authority (PRA) was formed as a subsidiary of the Bank of England (BoE) and the FSA transitioned to the Financial Conduct Authority (FCA) on 1 April 2013.

The transition of the FSA to the FCA comprised a name change (the legal entity that is the FSA continues post regulatory reform) and the transfer of circa 1,200 employees and certain assets and liabilities to the PRA and the BOE. The FCA's ability to raise funds from regulated entities and levy financial penalties will continue under the new Financial Services Act 2012, thus allowing the FCA to meet its statutory obligations.

The registered office is 25 The North Colonnade, Canary Wharf, London, E14 5HS.

These financial statements are presented in pounds sterling because that is the currency of the primary economic environment in which the FSA operates.

These financial statements are the final set of financial statements for the organisation known as the FSA.

## 2. Significant accounting policies

### a. Basis of preparation

- The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union and those parts of the Companies Act 2006 applicable to companies reporting under IFRS.

The financial statements separately disclose the Prudential Business Unit and other operations to be transferred including certain assets and liabilities, as operations to be transferred to the PRA and BoE on 1 April 2013.

The principal accounting policies applied in preparation of the financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

**b. Changes in accounting policy**

**(i) New and amended standards adopted by the FSA**

There were no IFRS or International Financial Reporting Interpretations Committee (IFRIC) interpretations effective for the first time in the financial year beginning on or after 1 April 2012 that have a material impact on the company.

**(ii) New standards, amendments and interpretations issued but not effective for the financial year 1 April 2012 and not early adopted**

**Amendment to IAS 19 'Employee Benefits'** The main change is that the expected rate of return on assets must be set equal to the discount rate, which will impact on the pension cost going forward. The effective date is 1 January 2013.

There are no other IFRS or IFRIC interpretations not yet effective that would be expected to have a material impact on the company.

**c. Statement of comprehensive income**

The format of the statement of comprehensive income has been designed to show net costs before fees levied to cover these costs. It is considered that this format best represents the nature of the activities of the FSA, which involve carrying out statutory functions and levying fees to meet the net cost of those functions.

**d. Revenue recognition**

Most revenue is receivable under the Financial Services and Markets Act 2000 (FSMA), is measured at fair value and represents the fees to which the FSA was entitled for the financial year.

Sundry income is recognised when it is received for services provided which includes fees for applications, publications and training services and recovery of Scope Change and professional fees.

Any surplus revenue from the United Kingdom Listing Authority (UKLA) is held in reserves until such time that it is used to pay for future relevant expenditure

Interest received on bank deposits is accrued on a time basis by reference to the principal outstanding and the effective interest rate applicable

**e. Property, plant and equipment**

Property, plant and equipment is stated at cost less accumulated depreciation and any impairment losses

Depreciation is calculated to write off the cost less estimated residual value on a straight-line basis over the expected useful economic lives. The principal useful economic lives used for this purpose are

Leasehold improvements	Ten years or lease expiry
Computer equipment (excluding software)	Up to five years
Furniture and equipment	Ten years
Motor vehicles	Four years

The assets' residual values and useful lives are reviewed and adjusted if appropriate at the end of each reporting period

Subsequent expenditure is only capitalised when it increases the future economic benefits embodied in the specific asset to which it relates

The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset, and is recognised in the statement of comprehensive income

**f. Intangible assets**

In accordance with IAS 38 Intangible Assets, costs associated with the development of software for internal use are capitalised only where the FSA can demonstrate the technical feasibility of completing the software, the FSA has adequate technical, financial and other resources available to it as well as the intent to complete its development, and, the FSA has the ability to use it upon completion. In addition, costs are only capitalised if the asset can be separately identified, it is probable that the asset will generate future economic benefits, and that the development cost of the asset can be measured reliably

Expenditure on research activities is recognised as an expense in the period in which it is incurred

Only costs that are directly attributable to bringing the asset to working condition for its intended use are included in its measurement. These costs include all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in a manner intended by management.

Intangible assets are amortised on a straight-line basis over their expected useful lives, generally between three and seven years, with the expense reported as an administration expense in the statement of comprehensive income. Subsequent expenditure is only capitalised when it increases the future economic benefits embodied in the specific asset to which it relates.

When software is not an integral part of the related hardware, it is treated as an intangible asset.

Where no intangible asset can be recognised, development expenditure is charged to the statement of comprehensive income when incurred.

**g. Impairment of property, plant and equipment, and intangible assets**

During the financial year the FSA reviews the carrying value of its property, plant and equipment and intangible assets to determine whether there is any indication that those assets have suffered impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss.

The recoverable amount is the higher of the fair value less costs to sell, and value in use. If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. An impairment loss is immediately recognised as an expense.

When an impairment loss subsequently reverses, the carrying amount is increased to the revised estimate of its recoverable amount but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. A reversal of an impairment loss is immediately recognised as income.

#### **h. Recognition of enforcement expenses**

All costs incurred to the end of the year are included in the financial statements but no provision is made for the costs of completing current work unless there is a present obligation

In the course of its enforcement activities, the FSA gives indemnities to certain provisional liquidators and trustees. Provisions are made in the accounts for costs incurred by such liquidators and trustees based on the amounts estimated to be recoverable from the FSA under such indemnities

#### **i. Financial penalties**

A liability to our fee payers arises when a financial penalty is received. This liability is limited to the sum of the enforcement costs for that year agreed with the Exchequer. Once total financial penalties collected during the year exceed this sum a liability to the Exchequer arises

Penalties levied and not yet collected at 31 March 2013 are included in both current assets 'trade receivables and remaining penalties uncollected' and current liabilities 'trade and other payables', subject to an assessment of recoverability

#### **j. Financial instruments**

**Trade receivables** are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method. Appropriate allowances for estimated irrecoverable amounts are recognised in the statement of comprehensive income when there is objective evidence that an asset is impaired. The allowance recognised is measured as the difference between an asset's carrying value and the estimated future cash-flows deriving from the continued use of that asset, discounted if the effect is material

**Trade payables** are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method

**Cash and cash equivalents** comprise cash in hand, deposits and other short-term liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value

The company's financial risk management policy is disclosed below

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### ***Credit risk***

The FSA's principal financial assets are cash deposits and cash, together with fee and other receivables

The FSA's credit risk falls into two main categories

- I the collection of fees from the financial services industry the FSA has a strong record in collecting fees with bad debt experience averaging at less than 0.3% of fees receivable over the last three years, and
- II the placement of those fees as deposits with various counter-parties the FSA only invests with those financial institutions that meet its minimum credit rating as assigned by credit rating agencies The FSA also spreads its deposits across a number of counter-parties in order to avoid concentration of credit risk

### ***Liquidity risk***

The FSA manages its liquidity by carefully monitoring the projected income and expenditure related to its day to day business Each month the FSA identifies long term liquidity up to the point when it next expects to bill the majority of fees The FSA also has available to it for liquidity purposes, retained financial penalties (limited to the sum of the agreed enforcement costs for that year) collected during the financial year, which will be returned to fee payers in the following financial year The FSA also has credit facilities available (see note 13)

### ***Interest rate risk***

Other than cash held in bank accounts, all of the FSA's cash and cash equivalents are fixed-rate fixed-term deposits and so are not sensitive to variations in interest rates

### ***k. Leasing***

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee All other leases are treated as operating leases

The FSA has no finance leases in place

Rentals payable under operating leases are charged to the statement of comprehensive income on a straight-line basis over the term of the lease Benefits received and receivable as an incentive to enter into an operating lease are also spread on a straight-line basis over the term of the lease term



## **I. Provisions**

Provisions are recognised when the FSA has a present obligation, legal or constructive, as a result of a past event, if it is probable that the FSA will be required to settle that obligation and the amount can be reliably estimated. Provisions are measured at the directors' best estimate, at the balance sheet date, of the expenditure required to settle the obligation.

### **m. Taxation**

The FSA is only liable to pay corporation tax on investment income subject to deductions for intangible fixed assets.

### **n. Retirement benefit costs**

The FSA operates a tax-approved occupational pension scheme, the FSA Pension Plan (the 'Plan'), which is open to all employees. The pension plan was established on 1 April 1998 and operates on both a defined benefit basis (the *Final Salary Section*), which is closed to new members and to future accruals, and a defined contribution basis (the *Money Purchase Section*).

#### ***Final Salary Section (defined benefit)***

The Final Salary Section of the Plan is a defined benefit plan. Typically, defined benefit plans define an amount of pension benefit that an employee will receive on retirement, usually dependent on rate of accrual, age, years of service in the plan and compensation.

The charge to the statement of comprehensive income is the past service and interest costs of the liabilities, less the expected return on the Plan's assets.

The net liabilities of the Final Salary Section of the Plan are calculated by deducting the fair value of the assets from the present value of its obligations and they are disclosed as a non-current liability on the balance sheet.

The obligation of the Final Salary Section of the Plan represents the present value of future benefits owed to employees in respect of their service in prior periods. The discount rate used to calculate the present value of those liabilities is the market rate at the balance sheet date of high quality corporate bonds having maturity dates approximating to the terms of those liabilities. The calculation is performed by a qualified actuary using the projected unit credit method at each balance sheet date.

Actuarial gains and losses arising in the Final Salary Section of the Plan (for example, the difference between actual and expected return on assets, effects of changes in assumptions and experience losses arising on scheme liabilities) are recognised in full in the statement of comprehensive income in the period in which they are incurred

Past service cost is recognised immediately to the extent that the benefits are vested and otherwise is amortised on a straight-line basis over the average period until the benefits become vested

With effect from 1 April 2010, members of the Final Salary Section of the Plan ceased to accrue further future benefits

### ***Money Purchase Section (defined contribution)***

The Money Purchase Section of the Plan is a defined contribution plan where the FSA pays fixed contributions to a separate entity. The FSA has no legal or constructive obligations to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods

Payments to the Money Purchase Section of the Plan are recognised as an expense in the statement of comprehensive income, as they fall due. Prepaid contributions are recognised as an asset to the extent that a cost refund or a reduction in future payments is available

### **3. Significant accounting judgements, estimates and assumptions**

In the process of applying the FSA's significant accounting policies as described in note 2, management has made the following judgements that have the most significant effect on the amounts recognised in the financial statements (apart from those involving estimates, which are dealt with below)

- i) **New regulatory structure and effect on the accounts** –The Financial Services Act 2012 came into effect on 1 April 2013 and we have reflected the impact this will have on the financial statements for 2012/13 and comparatives. We have done this in order to make the financial statements more transparent to the users

The statement of comprehensive income has been split between Operations to be transferred and Continuing operations

Operations to be transferred include the staff costs of the people moving to the PRA and the BoE on 1 April 2013 and the costs of the 18<sup>th</sup> and 25<sup>th</sup> floors of 1

Canada Square which will transfer to the BoE. Continuing operations reflect the costs of the divisions remaining with the FCA following legal cutover.

The statement of financial position has been split between Continuing operations and assets and liabilities to be transferred. This split reflects the assets and liabilities which will remain with the FCA and those that the BoE has agreed to purchase for net book value £3.5m. The net liability of £2.6m consists of the £3.5m less £6.1m income received in advance for the PRA. Material assets include internally developed software and computer equipment relating to Analytical Reporting Tool (ART) and Solvency II and furniture and fittings on the 18<sup>th</sup> and 25<sup>th</sup> floor of 1 Canada Square. The liability transferring relates to Solvency II income received in advance.

The statement of changes in equity has not been split reflecting the fact that the retained earnings will remain with the FCA.

- ii) Financial Penalties - Under FSMA the FSA had the power to levy financial penalties. Total financial penalty receipts were returned to fee payers in the form of a financial penalty rebate in accordance with our financial penalty scheme.

Following changes made by the Financial Services Act 2012, the FCA retains the power to levy financial penalties. However all financial penalty receipts from 1 April 2012, net of certain enforcement costs, are to be paid to the Exchequer. In 2012/13 we retained £38.2m of penalty receipts (representing the deductible enforcement costs). This forms the total rebate to be returned to fee payers in 2013/14.

- iii) Intangible assets – under IAS 38, internal software development costs of £29.1m (2012: £28.1m) have been capitalised as additions during the year. Internally developed software is designed to help the FSA carry out its various statutory functions, such as holding details relating to regulated firms. These functions are particular to the FSA, so this internally developed software generally has no market value. Management judgement has been applied in quantifying the benefit expected to accrue to the FSA over the useful life of the relevant assets. Those expected benefits relate to the fact that such software allows us to carry out our functions more efficiently than by using alternative approaches (for example, manual processing). If the benefits expected do not accrue to the FSA (for example, if some aspect of our approach to discharging our statutory functions changes, perhaps due to the impact of implementing a

European directive), then the carrying value of the asset would require adjustment

### ***Estimates and assumptions***

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, which have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are discussed below

- Pension deficit – the quantification of the pension deficit is based upon assumptions made by the directors (as listed in note 14) relating to the discount rate, retail price inflation (RPI), future pension increases and life expectancy
- Generally, the level of annual pension increases awarded by the Plan for pensions in payment is the annual increase in RPI, or 5.0% a year if lower, although some of the pension rights transferred in from the FSA's predecessor organisations receive different levels of pension increases

## **4. Business and geographical analysis**

We have restated the 2012 comparatives to reflect the split of the FSA into the two new regulatory bodies. The Prudential Business Unit and other operations to be transferred reflect the staff costs of the people moving to the PRA and the BoE on 1 April 2013 and the cost of the 18<sup>th</sup> and 25<sup>th</sup> floors of 1 Canada Square. Total continuing operations reflect the costs of the divisions remaining with the FCA following legal cutover. These include Conduct, Operations, Enforcement and Financial Crime and other central services divisions.

**Prudential Business Unit and other operations to be transferred** are responsible for

- the prudential supervision of a large spectrum of firms, including UK banks and building societies, insurance firms, and investment and overseas banks,
- the specialist supervision of those firms' risks including capital management, credit risk, market risk, asset and liability management, liquidity, counterparty risk, spanning all asset classes, and leading technological change in risk analytics to facilitate the research and assessment of micro-prudential risk of regulated firms, and
- the development of policy and consequent handbook rules covering prudential standards for firms, the implementation of the prudential regime for liquidity, capital, accounting, operational risk and governance, as well as the negotiation

of policy input into key prudential EU directives and specific international agreements

**Conduct** is responsible for delivering a forward looking judgement-based approach to supervision, with wide-ranging responsibilities covering risk identification and mitigation, policy formulation and markets-related issues. It aims to

- promote a well-regulated market that is efficient, orderly and fair,
- focus on fair outcomes for consumers and seek to ensure firms adhere to our conduct principles,
- contribute to a proportionate supervisory regime through effective risk identification and mitigation, and
- lead global regulatory reform by engaging with the European Supervisory Authorities and the wider European and international processes

**Operations** works in partnership with the rest of the business to deliver quality services and value for money. This includes the set-up and maintenance of processes and systems required to deliver the FSA's objectives. The division focuses on ensuring the company has the right people to deliver its regulatory strategy and that they are equipped with the appropriate tools and information needed to do their job to the best of their ability. The division also works to attract, develop and retain talented people, as well as managing enhancements to our capabilities, keeping the office buildings and systems running, managing the finances and looking after staff interests.

**Enforcement and Financial Crime Division (EFCD)** conducts investigations when firms breach our rules or the provisions of FSMA, and also includes a financial crime and intelligence function to support the FSA's strategic objectives. The EFCD carries out administrative, civil and criminal proceedings in the enforcement of FSMA, our rules and other regulatory requirements. It also works with other regulatory bodies and law enforcement agencies in the UK and abroad. The Financial Crime and Intelligence Department helps us to reduce the extent to which it is possible for a business to be used for financial crime. The department comprises policy, intelligence, sector and operations teams who together deal with any issues involving money laundering, fraud or dishonesty, or market abuse.

**Other central services** report directly to the Chairman and Chief Executive. The aim of these departments is to ensure that the Chairman and the Board are able to fulfil their stewardship and corporate governance responsibilities, and to provide support to the rest of the organisation.

Segmental information about the FSA's operations is presented below:

<b>Period ended 31 March 2013</b>	<b>Prudential and other operations to be transferred</b>	<b>Conduct</b>	<b>Operations</b>	<b>Enforcement &amp; Financial Crime</b>	<b>Other central services</b>	<b>Total Continuing operations</b>	<b>Total 2013</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Administrative costs	(187.6)	(200.7)	(63.2)	(67.8)	(63.8)	(395.5)	(583.1)
Interest on bank deposits	-	-	1.7	-	-	1.7	1.7
Other net finance costs	-	-	(5.0)	-	-	(5.0)	(5.0)
Other income	22.6	12.8	1.1	2.6	0.2	16.7	39.3
<b>Segmental Net costs for year</b>	<b>(165.0)</b>	<b>(187.9)</b>	<b>(65.4)</b>	<b>(65.2)</b>	<b>(63.6)</b>	<b>(382.1)</b>	<b>(547.1)</b>
Fee income	167.6	-	400.4	-	-	400.4	568.0
<b>Segmental Surplus / (deficit) before Taxation</b>	<b>2.6</b>	<b>(187.9)</b>	<b>335.0</b>	<b>(65.2)</b>	<b>(63.6)</b>	<b>18.3</b>	<b>20.9</b>
	-	-	1.8	-	-	1.8	1.8
<b>Segmental Surplus / (deficit) after taxation</b>	<b>2.6</b>	<b>(187.9)</b>	<b>336.8</b>	<b>(65.2)</b>	<b>(63.6)</b>	<b>20.1</b>	<b>22.7</b>

<b>Period ended 31 March 2012 Restated<sup>1</sup></b>	<b>Prudential and other operations to be transferred</b>	<b>Conduct</b>	<b>Operations</b>	<b>Enforcement &amp; Financial Crime</b>	<b>Other central services</b>	<b>Total Continuing operations</b>	<b>Total 2012</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Administrative costs	(185.8)	(156.9)	(74.8)	(76.3)	(32.3)	(340.3)	(526.1)
Interest on bank deposits	-	-	1.8	-	-	1.8	1.8
Other net finance costs	-	-	(4.2)	-	-	(4.2)	(4.2)
Profit on disposal	-	12.8	-	-	-	12.8	12.8
Other income	23.8	10.1	8.6	1.5	1.7	21.9	45.7
<b>Segmental Net costs for year</b>	<b>(162.0)</b>	<b>(134.0)</b>	<b>(68.6)</b>	<b>(74.8)</b>	<b>(30.6)</b>	<b>(308.0)</b>	<b>(470.0)</b>
Fee income	167.2	-	338.7	-	-	338.7	505.9
<b>Segmental surplus / (deficit) before Taxation</b>	<b>5.2</b>	<b>(134.0)</b>	<b>270.1</b>	<b>(74.8)</b>	<b>(30.6)</b>	<b>30.7</b>	<b>35.9</b>
	-	-	(0.4)	-	-	(0.4)	(0.4)
<b>Segmental surplus / (deficit) after taxation</b>	<b>5.2</b>	<b>(134.0)</b>	<b>269.7</b>	<b>(74.8)</b>	<b>(30.6)</b>	<b>30.3</b>	<b>35.5</b>

<sup>1</sup> Restated - The 2012 comparatives have been restated to reflect the split of the FSA into the two new regulatory bodies

### ***Geographical analysis***

The FSA regulates entities that operate within the UK financial services industry, including the regulation of foreign domiciled entities operating within the UK. The foreign domiciled entities account for less than 10% of the fee base of the FSA therefore no geographical analysis is presented.

### **5. Surplus before taxation**

The surplus before taxation for the period ending 31 March 2013 has been arrived at after charging/(crediting) the following:

	<b>Note</b>	<b>2013 £m</b>	<b>2012<sup>1</sup> £m</b>
Depreciation of property, plant and equipment	10	18.4	16.4
Amortisation of intangible assets	9	23.1	15.9
Impairment loss	9/10	12.5	5.8
Staff costs	6	326.9	301.9
Operating lease rentals		13.7	15.2
Loss on disposal	9/10	-	0.8
Profit on disposal		-	(12.8)
Regulatory reform costs		28.7	11.4

At 31 March 2013, a pre-tax surplus with a value of £2.6m (2012: £5.2m) was identified as being related to operations to be transferred to the PRA and BoE.

In accordance with our accounting policy, we review the carrying value of intangible assets annually to determine whether there has been any impairment loss, and if so, the extent.

On 24 October 2011, the FSA sold the Transaction Reporting System (TRS) to the London Stock Exchange. The net profit on disposal was £12.8m.



## Auditors

The National Audit Office was appointed as auditor on the 24 August 2010

The auditor's remuneration for audit services is set out below:

<b>Total fees</b>	<b>12 months to 31 March 2013 £'000</b>	<b>12 months to 31 March 2012 £'000</b>
Fees payable to the National Audit Office for the audit of the FSA's annual accounts (excluding VAT)	80	70

## 6. Employee information

The average number of full-time equivalent employees (including executive directors) during the year to March 2013 was 3,596 (2012 3,416). The average number of permanent full-time equivalent employees in each business unit/ division during the year was as follows

	<b>2013</b>	<b>Restated<sup>1</sup> 2012</b>
Prudential	968	1,040
Conduct	1,452	1,263
Operations	624	560
Enforcement and Financial Crime	396	408
Other central services	156	145
<b>Total</b>	<b>3,596</b>	<b>3,416</b>

<sup>1</sup> Restated - The 2012 figures have been restated to reflect the organisational change

As at 31 March 2013, the FSA had 3,631 (2012 3,502) permanent full-time equivalent employees on its payroll

At 31 March 2013, the total number of full-time equivalent employees including contractors and secondees transferred to the PRA and BoE was 1,197

**Employment costs (including executive directors) comprise:**

	Notes	2013 £m	Restated <sup>1</sup> 2012 £m
Gross salaries and taxable benefits		268 7	247 4
Employer's national insurance costs		32 7	30 4 <sup>1</sup>
Employer's defined contribution costs	14	25 2	24 0 <sup>2</sup>
Other employer's pension costs included in administrative costs		0 3	0 1
	5	326 9	301 9
Net pension finance costs (included in other finance costs)	14	5 0	4 2
Actuarial losses in respect of the defined benefit pension scheme	14	43 9	7 9
<b>Total employment costs</b>		<b>375.8</b>	<b>314.0</b>

<sup>1</sup> Restated - National insurance costs of £4 8m relating to incentive payments that were disclosed in Gross Salaries and taxable benefits in the prior year have been reclassified into Employer's national insurance costs

<sup>2</sup> Restated - Pension contributions of £8 0m made by employees that were disclosed in Employer's defined pension contribution costs in prior year have been reclassified into Gross salaries and taxable benefits

At 31 March 2013, employment costs with a value of £116 9m (2012 £109 7m) were identified as relating to operations to be transferred

**7. Other income**

Other income comprises

	2013 £m	2012 £m
Application fees and other regulatory income	9 1	10 7
Transaction reporting services	-	3 7
Publications and training services	1 4	1 4
Solvency II income	18 3	23 0

Professional fees recovered	4.1	0.7
Other sundry income	6.4	6.2
<b>Total other income</b>	<b>39.3</b>	<b>45.7</b>

At 31 March 2013, other income with a value of £22.6m (2012 £23.8m) was identified as relating to operations to be transferred

## 8. Taxation

The tax (credit)/charge on ordinary activities is

	<b>2013 £m</b>	<b>2012 £m</b>
2008/09	(0.9)	-
2009/10	(0.1)	-
2010/11	(0.4)	-
2011/12	(0.4)	0.4
<b>Corporation tax (credit)/charge for the year</b>	<b>(1.8)</b>	<b>0.4</b>

Under a longstanding agreement with Her Majesty's Revenue and Customs (HMRC), the FSA is not subject to corporation tax on income arising from its regulatory activities but is subject to corporation tax on net investment income. The adjustments in respect of prior years result from the application of the corporation tax regime for intangible fixed assets which led to a tax credit of £1.8m.

There is an unrecognised deferred tax asset of £13.9m (2012 £7.1m) in relation to unused tax losses carried forward. This relates to the application of the corporation tax regime for intangible fixed assets. It is not considered probable that taxable profit will be available against which the unused tax losses can be utilised.

The total charge for the year can be reconciled to the accounting surplus as follows:

	<b>2013 £m</b>	<b>2012 £m</b>
<b>Surplus before tax</b>	<b>20.9</b>	<b>35.9</b>

Tax at 24% (2012 26%) thereon	5 0	9 3
Effects of		
Adjustment for activities not subject to corporation tax	(5 0)	(8 9)
Current tax charge for the year	-	0 4
Effective tax rate for the year	0 0%	1 1%

## 9. Intangible assets

	Internally generated software £m	Other software costs £m	Total £m
<b>Cost</b>			
<b>At 1 April 2011</b>	<b>123.1</b>	<b>-</b>	<b>123.1</b>
Additions	28 1	-	28 1
Transfers	-	23 5	23 5
Disposals	(0 8)	-	(0 8)
Impairments	(12 8)	-	(12 8)
<b>At 31 March 2012</b>	<b>137.6</b>	<b>23.5</b>	<b>161.1</b>
Additions	28 3	0 8	29 1
Transfers	-	6 6	6 6
Disposals	(27 6)	(5 3)	(32 9)
Impairments	(8 6)	-	(8 6)
<b>At 31 March 2013</b>	<b>129.7</b>	<b>25.6</b>	<b>155.3</b>
<b>Amortisation</b>			
<b>At 1 April 2011</b>	<b>45.9</b>	<b>-</b>	<b>45.9</b>
Charge for the year	15 9	-	15 9
Transfers	-	10 8	10 8
Disposals	(0 2)	-	(0 2)
Impairments	(7 4)	-	(7 4)
<b>At 31 March 2012</b>	<b>54.2</b>	<b>10.8</b>	<b>65.0</b>
Charge for year	22 0	1 1	23 1
Transfers	4 3	0 8	5 1

Disposals	(27.7)	(5.4)	(33.1)
Impairments	1.1	-	1.1
<b>At 31 March 2013</b>	<b>53.9</b>	<b>7.3</b>	<b>61.2</b>
<b>Net book value</b>			
<b>At 31 March 2012</b>	<b>83.4</b>	<b>12.7</b>	<b>96.1</b>
<b>At 31 March 2013</b>	<b>75.8</b>	<b>18.3</b>	<b>94.1</b>

At 31 March 2013, work in progress with a net book value of £18.4m (2012 £29.7m) was included in internally generated software

At 31 March 2013, intangible assets with a value of £15.0m (2012 £11.2m) were identified as intangible assets to be transferred to the PRA and BoE

## 10. Property, plant and equipment

	Leasehold improvements £m	Computer equipment £m	Furniture and equipment £m	Total £m
<b>Cost</b>				
<b>At 1 April 2011</b>	38.0	108.8	16.2	163.0
Additions	0.5	12.1	0.3	12.9
Transfers	-	(23.5)	-	(23.5)
Disposals	-	(3.0)	-	(3.0)
Impairments	-	(0.9)	-	(0.9)
<b>At 31 March 2012</b>	<b>38.5</b>	<b>93.5</b>	<b>16.5</b>	<b>148.5</b>
Additions	1.9	8.8	0.5	11.2
Transfers	-	(6.6)	-	(6.6)
Disposals	(13.1)	(38.0)	(1.3)	(52.4)
Impairments	-	(0.7)	-	(0.7)
<b>At 31 March 2013</b>	<b>27.3</b>	<b>57.0</b>	<b>15.7</b>	<b>100.0</b>
<b>Accumulated depreciation</b>				
At 1 April 2011	19.1	61.7	4.9	85.7
Charge for year	2.7	12.4	1.3	16.4
Transfers	-	(10.8)	-	(10.8)
Disposals	-	(2.8)	-	(2.8)
Impairments	-	(0.5)	-	(0.5)
<b>At 31 March 2012</b>	<b>21.8</b>	<b>60.0</b>	<b>6.2</b>	<b>88.0</b>
Charge for year	2.8	14.0	1.6	18.4
Transfers	-	(5.1)	-	(5.1)
Disposals	(13.1)	(37.9)	(1.2)	(52.2)
Impairments	1.6	0.4	0.1	2.1
<b>At 31 March 2013</b>	<b>13.1</b>	<b>31.4</b>	<b>6.7</b>	<b>51.2</b>
<b>Carrying amount</b>				
<b>At 31 March 2012</b>	<b>16.7</b>	<b>33.5</b>	<b>10.3</b>	<b>60.5</b>
<b>At 31 March 2013</b>	<b>14.2</b>	<b>25.6</b>	<b>9.0</b>	<b>48.8</b>

At 31 March 2013, expenditure classified as work in progress with a net book value of £4.5m (2012: £8.3m) was included in property, plant and equipment.

The FSA has reviewed the residual values used for depreciation calculations, with appropriate provisions made. This review did not identify any requirement for adjustment to the residual values used in the current or prior periods.

At 31 March 2013, property, plant and equipment with a value of £3.0m (2012: £3.5m) was identified to be transferred to the PRA and BoE.

## 11. Current assets

	Note	2013 £m	2012 £m
Fees receivable		7.6	1.2
Financial penalties receivable	12	44.3	1.7
Other debtors		1.7	10.6
Prepayments and accrued income		14.8	17.4
<b>Trade and other receivables</b>		<b>68.4</b>	<b>30.9</b>
Cash deposits		390.6	72.0
Cash		1.4	-
<b>Cash and cash equivalents</b>		<b>392.0</b>	<b>72.0</b>
Current tax asset	8	2.1	-
<b>Total current assets</b>		<b>462.5</b>	<b>102.9</b>

At 31 March 2013, current assets with a value of £1.1m (2012: £0.6m) were identified to be transferred to the PRA and the BoE.

Of the total cash deposits of £390.6m (2012: £72.0m), £343.7m (2012: Nil) relates to penalties collected on behalf of the Exchequer (see note 12).

The average credit period is 34 days (2012: 34 days). A late penalty charge of £250 is payable on periodic fees not paid by the due date. If payment is not received by the due date, interest is charged on the outstanding balance at the Bank of England Repo rate plus 5%.

In accordance with IFRS 7, with the exception of prepayments and accrued income, all items within current assets are classified as loans and receivables.

All of the FSA's fee and other receivables have been reviewed for indications of impairment. Certain fee receivables were found to be impaired and a provision of £0.7m (2012: £0.5m) has been made for the estimated



irrecoverable amounts from fees invoiced. This provision has been determined by reference to past default experience.

Financial penalties receivable were also reviewed for impairment and a provision made as set out below. These provisions are offset against the amounts receivable.

	2013 £m	2012 £m
1 April	14.6	6.6
Increase in provision for financial penalties	0.9	8.0
<b>At 31 March</b>	<b>15.5</b>	<b>14.6</b>

The directors consider that the carrying amount of trade and other receivables approximates to their fair value.

In addition, some of the unimpaired fee receivables are past due as at 31 March 2013. The age of fee receivables past due, but not impaired, is as follows:

	2013 £m	2012 £m
Not more than three months	0.8	0.2
More than one year	0.1	0.1
<b>Total</b>	<b>0.9</b>	<b>0.3</b>

Our policy is to review receivables systematically for recoverability when they are more than three months past due. The amounts above are in the course of collection and we have had no specific evidence that any of these receivables are impaired.

The majority of the more than one year debt relates to a single debt. We expect payment of this in full from the firm's administrator.

### **Cash and cash equivalents**

Bank balances and cash comprise cash held by the FSA and short-term fixed-rate bank deposits with a maturity date of 12 months or less. The carrying amount of these assets approximates to their fair value.

## **12. Liabilities**

### **Current liabilities**

	<b>2013</b>	<b>Restated<sup>1</sup></b>
	<b>£m</b>	<b>2012</b>
		<b>£m</b>
Trade creditors and accruals	93.7	79.8 <sup>1</sup>
Other taxation and social security	13.3	13.3 <sup>1</sup>
Total financial penalties liabilities	426.2	71.7
Fees received in advance	32.2	35.3
<b>Trade and other payables</b>	<b>565.4</b>	<b>200.1</b>
Current tax liabilities	-	0.2
Borrowings	-	1.2
<b>Total current liabilities</b>	<b>565.4</b>	<b>201.5</b>

<sup>1</sup> Restated - National insurance costs of £4.8m relating to incentive payments that were disclosed in Trade creditors and accruals in 2012 have been reclassified into Other taxation and social security.

At 31 March 2013, current liabilities with a value of £21.7m (2012: £18.6m) were identified to be transferred to the PRA and BoE.

### **Liabilities relating to financial penalties**

	<b>2013</b>	<b>2012</b>
	<b>£m</b>	<b>£m</b>
Penalties to be applied against future fees receivable (for 2013 this is equal to deductible enforcement costs)	38.2	70.0
Current liability to Exchequer at 31 March	343.7	-
Penalties uncollected at 31 March	44.3	1.7
<b>Total financial penalties liabilities</b>	<b>426.2</b>	<b>71.7</b>

### Penalties Uncollected

	2013	2012
	£m	£m
Penalties uncollected at 1 April	16.3	8.3
Penalties issued during the year	427.2	78.7
Write-offs during the year	(1.8)	-
Penalties collected during the year	(381.9)	(70.7)
Penalties uncollected at 31 March	59.8	16.3
Provision for bad debts	(15.5)	(14.6)
<b>Net penalties uncollected at 31 March</b>	<b>44.3</b>	<b>1.7</b>

### Penalties Collected

	2013	2012
	£m	£m
Penalties to be applied against future fees receivable	38.2	70.7
Penalties to Exchequer	343.7	-
<b>Penalties collected during the year</b>	<b>381.9</b>	<b>70.7</b>

Interest accrued of £0.4m on penalties received and held on behalf of the Exchequer from the 1 January 2013 to 31 March 2013 is included in current liabilities

Trade creditors and accruals principally comprise amounts outstanding for trade purchases and on-going costs. The average credit period taken for trade payables is 27 days (2012: 24 days). The directors consider the carrying amount of trade payables approximates to their fair value.

In accordance with IFRS 7, the following items are classified as financial liabilities measured at amortised cost:

- trade creditors and accruals, and
- financial penalties

As at 31 March 2013, the FSA's liabilities have contractual maturities which are summarised below:

	Current			
	Within 6 months		6 to 12 months	
	2013 £m	2012 £m	2013 £m	2012 £m
Trade creditors and accruals	99.2	84.3	0.7	0.3
Fees in advance	26.1	35.3	-	-
Other liabilities	439.4	81.6	-	-
<b>Total</b>	<b>564.7</b>	<b>201.2</b>	<b>0.7</b>	<b>0.3</b>

## Non-current liabilities

### Non-current liabilities measured at amortised cost

	2013 £m	2012 £m
Lease accrual	12.6	15.9
Solvency II	-	1.1
<b>Total non-current liabilities</b>	<b>12.6</b>	<b>17.0</b>

The lease accrual of £12.6m (2012: £15.9m), being the cumulative difference between cash paid and expense recognised on operating leases for land and buildings, is recognised as a long-term liability. Details of the FSA's operating leases are set out in note 16.

As at 31 March 2013, the FSA's liabilities have contractual maturities that are summarised below:

	Non-current			
	1 to 5 years		Later than 5 years	
	2013 £m	2012 £m	2013 £m	2012 £m
Trade creditors and accrual	10.2	9.9	2.4	6.4
Fees in advance	-	0.7	-	-

<b>Total</b>	<b>10.2</b>	<b>10.6</b>	<b>2.4</b>	<b>6.4</b>
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### **13. Credit Facilities**

At the 31 March 2013 the available credit facilities were £76m, made up of a £75m revolving credit facility with HSBC Banking Group and a £1m overdraft facility with Lloyds Banking Group. The current available credit facilities of £115m are made up of two £50m undrawn committed borrowing facilities and an undrawn £15m overdraft facility.

These revolving credit facilities with Lloyds Banking Group and HSBC Banking Group expire on 24 April 2014, with any drawings made on the day prior to expiry being repayable in full by 24 April 2014.

The overdraft facility with Lloyds is available until further notice and will be reviewed periodically by the bank.

Any borrowings drawn under the above facilities would be unsecured.

### **14. Retirement benefit obligation**

Since 1 June 1998, all employees joining the FSA, other than those joining from other regulatory bodies whose functions were transferred to the FSA, have been eligible only for the *Money Purchase Section* of the Plan. The *Money Purchase Section* is part of a flexible benefits programme and members can, within limits, select the amount of their overall benefits allowance that is directed to their pension plan.

From 1 April 2010, following consultation with members, the FSA ceased the accrual of future service regarding members of the *Final Salary Section* of the Plan. All active members of the *Final Salary Section* became deferred members at this date and their benefits calculated based on their Final Pensionable Salary as at 31 March 2010. Future salary increases after 31 March 2010 will not impact these members' pensions and their pension (in excess of any Guaranteed Minimum Pension) will increase broadly in line with the RPI for the period up to their retirement. From 1 April 2010, these members were also offered membership of the *Money Purchase Section*.

### ***Final Salary Section***

The most recent actuarial valuation of the FSA Pension Plan was carried out as at 31 March 2010 by an independent actuary, using the projected unit method, and was signed in March 2011. The results of this valuation have been updated for the purpose of IAS 19 as at March 2013, in order to allow for any changes in assumptions and movements in liabilities over the period.

The major assumptions used for the purpose of actuarial assumptions were as follows:

<b>At 31 March</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Corporate bond discount rate	4.55%	5.25%	5.60%
Expected return on plan assets	n/a <sup>1</sup>	5.25%	6.05%
Retail price inflation (RPI)	3.45%	3.30%	3.50%
Future pension increases	3.15%	3.05%	3.35%

1 – The expected return on assets assumptions as at 31 March 2013 is no longer required under the new IAS 19 accounting standard.

The change in discount rate has resulted in an increase of £68.6m in the present value of the pension fund obligation.

The change in the RPI assumption (including the impact on expected future pension increases) has resulted in an increase of £12.8m in the present value of the pension fund obligation and the deficit of the Plan.

In assessing the value of funded obligations, the mortality assumptions for the Plan are based on current mortality tables and allow for future improvements in life expectancy. The mortality assumptions for 2013 are based on an actuarial table 'SAPS Light, with CMI 2009 projections and a 1.25% floor'.

The table below illustrates the assumed life expectancies of staff when they retire.

	<b>2013 Years</b>	<b>2012 Years</b>	<b>2011 Years</b>
<b>Retiring today aged 60</b>			
Males	28 6	28 5	28 5
Females	29 8	29 7	29 6
<b>Retiring in 15 years aged 60</b>			
Males	30 0	29 9	29 8
Females	31 3	31 2	31 1

The results of the pension valuation are sensitive to changes in all of the assumptions referred to above. The table below provides an estimate of the sensitivity of the present value of pension obligations, and the cost of servicing those obligations, to small movements in those assumptions.

Assumption	Sensitivity	Increase/(decrease) in pension obligation at 31 March 2013		Increase/(decrease) in estimated pension cost for 31 March 2014	
		£m	%	£m	%
Present value of funded obligation	Assumptions as above – no change	574.0	-	4.7	-
Discount rate	10 bps increase to 4.65%	(10.8)	(1.9%)	(0.4)	(8.6%)
Discount rate	10 bps decrease to 4.45%	11.2	1.9%	0.4	8.5%
Longevity	1 additional year of life at age 60	13.4	2.3%	0.6	13.1%
Inflation	10 bps increase to 3.55%	7.5	1.3%	0.3	7.3%

The amounts recognised in the statements of financial position are

	2013 £m	2012 £m	2011 £m
Fair value of Plan assets	461.9	375.9	339.7
Less Present value of funded obligations	(574.0)	(480.7)	(451.9)
<b>Deficit in the scheme</b>	<b>(112.1)</b>	<b>(104.8)</b>	<b>(112.2)</b>
Unfunded pension liabilities	(2.6)	(2.3)	(2.3)
<b>Net liability recognised in the statement of financial position</b>	<b>(114.7)</b>	<b>(107.1)</b>	<b>(114.5)</b>

A small number of current and former employees have benefit commitments that cannot be delivered entirely through the tax-approved scheme described above. At 31 March 2013 the liability is £2.6m (2012: £2.3m, 2011: £2.3m) to cover the cost of these commitments.



Amounts recognised in the statement of comprehensive income in respect of the defined benefit plan are as follows

	2013 £m	2012 £m	2011 £m
Expected return on plan assets	19.9	20.8	21.1
Interest cost on plan liabilities	(24.9)	(25.0)	(24.1)
<b>Other net finance costs</b>	<b>(5.0)</b>	<b>(4.2)</b>	<b>(3.0)</b>

Actuarial losses of £43.9m (2012 £7.9m, 2011 £13.3m) are recognised in the period in which they occur as part of the statement of comprehensive income

Changes in the present value of the defined benefit obligation are as follows

	2013 £m	2012 £m	2011 £m
Opening obligation	(480.7)	(451.9)	(427.2)
Benefits paid	13.0	9.7	9.9
Interest cost on scheme liabilities	(24.9)	(25.0)	(24.1)
Actuarial (losses)	(81.4)	(13.5)	(10.5)
<b>Closing obligation</b>	<b>(574.0)</b>	<b>(480.7)</b>	<b>(451.9)</b>

Changes in the fair value of the Plan assets are as follows

	2013 £m	2012 £m	2011 £m
Opening fair value of plan assets	375.9	339.7	316.6
Expected return on plan assets	19.9	20.8	21.1
Actuarial gains/(losses)	37.5	5.6	(2.8)
Contributions by the employer	41.6	19.5	14.7
Benefits paid	(13.0)	(9.7)	(9.9)
<b>Closing fair value of Plan assets</b>	<b>461.9</b>	<b>375.9</b>	<b>339.7</b>

The fair value of the Plan assets and the expected rates of return are

	Expected rate of return	Fair value £m	Expected rate of return	Fair value £m	Expected rate of return	Fair value £m
	At 31 March 2013		At 31 March 2012		At 31 March 2011	
Equity securities	n/a <sup>1</sup>	223.9	6.2%	171.1	7.1%	169.5
Debt securities	n/a <sup>1</sup>	184.7	4.2%	171.8	4.9%	140.4
Real estate	n/a <sup>1</sup>	28.1	5.1%	29.2	6.0%	27.2
Cash	n/a <sup>1</sup>	25.2	0.5%	3.8	0.5%	2.6
<b>Closing fair value of Plan assets</b>	<b>n/a</b>	<b>461.9</b>	<b>5.3%</b>	<b>375.9</b>	<b>6.1%</b>	<b>339.7</b>

1 – The expected return on assets assumptions as at 31 March 2013 are no longer required under the new IAS 19 accounting standard

Cumulative actuarial losses recognised in the statement of earnings

	2013 £m	2012 £m	2011 £m
Losses) at 1 April	(113.1)	(105.2)	(91.9)
Net actuarial losses recognised in the year	(43.9)	(7.9)	(13.3)
<b>At 31 March</b>	<b>(157.0)</b>	<b>(113.1)</b>	<b>(105.2)</b>

There are no deferred tax implications of the above deficit as corporation tax is only payable on interest receivable by the FSA

The Plan assets do not include any of the FSA's own financial instruments, nor any property occupied by, or other assets used by the FSA

The expected rates of return on individual categories of Plan assets are determined by reference to relevant market expectations at the beginning of the period for returns over the lifetime of the obligations

The history of differences between expected and actual returns on plan assets and gains and losses on Plan liabilities is as follows

	2013	2012	2011	2010	2009
Defined benefit obligation (£'m)	(574.0)	(480.7)	(451.9)	(427.2)	(310.0)
Fair value of Plan assets (£'m)	461.9	375.9	339.7	316.6	222.8
<b>Net deficit (£'m)</b>	<b>(112.1)</b>	<b>(104.8)</b>	<b>(112.2)</b>	<b>(110.6)</b>	<b>(87.2)</b>
Experience gains/(losses) on Plan assets					
Amount (£m)	37.5	5.5	(2.8)	68.4	(78.1)
Percentage of Plan assets	8.1%	1.5%	(0.8%)	21.6%	(35.1%)
Experience gains/(losses) on Plan liabilities					
Amount (£m)	nil	nil	(13.5)	(0.6)	0.6
Percentage of the present value of Plan liabilities	0.0%	0.0%	(3.0%)	(0.2%)	0.2%

As the Plan closed to future benefit accrual with effect from 31 March 2010 no accrual funding contributions were paid after that date. A Recovery Plan was put in place following the Scheme Specific Valuation (SSV) as at March 2010 and requires an annual deficit contribution of £19.8m (£19.5m for the FSA and £0.3m for the Financial Ombudsman Service) to be paid over the 10 years from 1 April 2011 with the aim of removing the Plan deficit

In order to mitigate the risks of significantly increased future annual pension deficit funding contributions the FSA decided to make a one-off additional £22.1m contribution in March 2013 to reduce the defined benefit pension scheme deficit that will be inherited by the FCA

#### ***Money Purchase Section (defined contribution)***

The total expense recognised in the statement of comprehensive income of £25.2m (2012 £24.0m) represents contributions payable to the plan by the FSA at rates specified in the rules of the Plan

## **15. Capital commitments**

The FSA had entered into contracts at 31 March 2013 for future capital expenditure totalling £5.5m (2012 £6.8m), which is not provided for in the accounts

## **16. Operating lease arrangements**

At the balance sheet date, the FSA had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows

	<b>2013 £m</b>	<b>2012 £m</b>
Within one year	18.1	20.0
In the second to fifth years inclusive	69.4	74.5
After five years	10.9	38.0
<b>Total</b>	<b>98.4</b>	<b>132.5</b>

Operating lease payments include rentals payable by the FSA for certain of its office properties. The FSA's significant lease arrangement is for 25 The North Colonnade, Canary Wharf.

## **17. Related party transactions**

### **Remuneration of key management personnel**

The remuneration of key management personnel of the FSA is set out below in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. The key management personnel includes executive board members, the chairman and FSA directors. This includes senior management acting in the role of director for more than 3 months. Of this group, 25 (2012 26) personnel received remuneration of £100k or more for the year. Further information on individual executive directors is provided in the audited part of the Corporate Governance Statement.

	<b>2013 £m</b>	<b>2012 £m</b>
Short-term benefits	7.1	7.9
Post-employment benefits	0.8	0.8
Termination benefits	0.3	0.6
<b>Total</b>	<b>8.2</b>	<b>9.3</b>

There were no other transactions with key management personnel in either year.

### ***Significant transactions with other financial services regulatory organisations***

The FSA enters into transactions with a number of other financial services regulatory organisations. The nature of the FSA's relationship with these organisations and the significant transactions entered into between the FSA and these organisations are set out below.

Whilst the FSA is required under various statutes to establish the financial services regulatory organisation set out in a) to d) below, it is the individual organisations themselves that are required to perform the functions.

Separately, while the FSA has the right to appoint and remove the directors of the various organisations, the Companies Act 2006 requires that the appointed directors have to exercise independent judgement

The fact that the FSA does not have statutory responsibility for the functions of these organisations means that its separate powers to appoint and remove directors to the boards of these organisations, cannot be exercised for the benefit of the FSA. The failure to meet this test means that the FSA does not control these organisations as defined under International Accounting Standard 27 – Consolidated and Separate Financial Statements. It does, however, consider these organisations to be related parties

a) The Financial Services Compensation Scheme Limited (FSCS)

During the year, the FSA provided an agency service to FSCS to collect tariff data, issue levy invoices and collect levy monies on its behalf. The charge for the service was £0.4m (2012: £0.3m). The net amount of fees collected that remained to be paid over by the FSA to FSCS at 31 March 2013 was £0.8m (2012: £nil).

b) The Financial Ombudsman Service Limited (the ombudsman service)

The FSA is the principal employer in the FSA Pension Scheme described in note 14. The ombudsman service is also a participating employer in the same scheme making contributions at the same overall rate as the FSA.

In 2005/06 the FSA entered into an agency agreement with the ombudsman service to collect tariff data, issue levy invoices and collect levy monies on its behalf regarding its fees for 2006/07 onwards. The charge for that service in the current year was £0.1m (2012: £0.1m). As at 31 March 2013, £1.1m of fees (including on-account fees) relating to 2013/14 invoices had been collected but not paid to the ombudsman service (2012: £0.1m).

The FSA acts as guarantor to the lease agreement for part of the ombudsman service premises. The lease is due to end on 1<sup>st</sup> November 2014.

c) Money Advice Service (MAS)

The FSA provides a revenue collection service to the MAS. The charge for this service in the period ended 31 March 2013 was £0.1m (2012: £2.3m).

As at 31 March 2013, the amount collected but not paid to the MAS was £3.1m, including 2013/14 on-account fees (2012: £0.1m).

d) The Office of the Complaints Commissioner (OCC)

The FSA funds the activities of the Complaints Commissioner through the periodic fees it raises. Up to 31 August 2004, the costs of those activities were met directly by the FSA. In August 2004, the OCC, a company limited by guarantee, was incorporated. Since 1 September 2004, the purpose of this company has been to administer complaints against the FSA that are handled by the Complaints Commissioner. In doing so, it employs staff, owns assets used by the Commissioner and his staff, and enters into contracts for goods and services in furtherance of complaints handling activities. During 2012/13, the FSA transferred £0.6m (2012: £0.6m) to the OCC to cover the latter's running costs, which have been expensed in the FSA's statement of comprehensive income. At 31 March 2013 the balance owing to the FSA from the OCC was £nil (2012: £nil).

The FSA acts as guarantor to the lease agreement for the OCC's premises. The lease is due to end in October 2016.

By virtue of certain provisions contained in the Memorandum of Association of the OCC, the FSA has the right to appoint and remove the Complaints Commissioner, who is both a member, and a director of the company and as such has the ability to control the OCC. Because of this, the OCC is a subsidiary of the FSA. However, the scale of the activities of the OCC is immaterial compared to that of its parent company. Accordingly, the FSA has not prepared group accounts to include the OCC, on the grounds that the exclusion of the OCC from the FSA's accounts is not material to those accounts providing a true and fair view.

## 18. Notes to the cash flow statement

	Notes	2013 £m	Restated <sup>1</sup> 2012 £m
Surplus for the year from operations		20.9	35.9
Adjustments for			
Interest received on bank deposits		(1.7)	(1.8)
Amortisation of other intangible assets	9	23.1	15.9
Impairment loss on intangible assets	9	9.7	3.2
Loss on disposal of intangible assets	9	(0.2)	0.6
Depreciation of property, plant and equipment	10	18.4	16.4
Loss on disposal of property, plant and equipment	10	0.2	0.2
Impairment loss on tangible assets	10	2.8	0.4
Profit on disposal		-	(12.8)
Difference between pension costs and normal contributions	14	5.0	4.2
Payments made on unfunded pension liability	14	0.3	-
Additional cash contributions to reduce pension scheme deficit	14	(41.6)	(19.5)
<b>Operating cash flows before movements in working capital</b>		<b>36.9</b>	<b>42.7</b>
Increase in receivables	11	(39.6)	(15.4)
Increase/(decrease) in payables	12	360.7	(32.0)
<b>Net cash generated from/(used by) operations</b>		<b>358.0</b>	<b>(4.7)</b>

<sup>1</sup> Restated – The prior year figures have been restated to reflect a correction to the Impairment loss on intangible assets

## 19. Events after the reporting period

As part of the Financial Services Act 2012 the PRA was formed as subsidiary of the BoE and the FSA transitioned to the FCA on 1 April 2013, the effect of which has been disclosed in the financial statements. There were no other events after the reporting period.



## Section Eleven: Glossary

AFP – Arch Financial Products  
AIFMD – Alternative Investment Fund Managers Directive  
AML – anti-money laundering  
ART – Analytics & Risk Technology  
BCBS – Basel Committee on Banking Supervision  
BIS – Department for Business, Innovation and Skills  
BMA – Business Model Analysis  
BoE – Bank of England  
CASS – Client assets  
CBU – conduct business unit  
CCPs – central counterparties  
CDS – credit default swap  
CFD – Contract for Difference  
CIIA – Chartered Institute of Internal Auditors, UK  
CMAR – Client Money and Assets return  
CPP – Card Protection Plan Limited  
CRA's – Credit Ratings Agencies  
CRDIV – Capital Requirements Directive  
DGSD – Deposit Guarantee Schemes Directive  
DWF – Discount Window Facility  
EBA – European Banking Authority's  
EIOPA – European Insurance and Occupational Pensions Authority  
EMIR – European Market Infrastructure Regulation  
ESAs – European Supervisory Authorities  
ESMA – European Securities and Markets Authority  
FATF – Financial Action Task Force's  
FCA – Financial Conduct Authority  
FMI – Financial Market Infrastructure  
FOS – Financial Ombudsman Service  
FPC – Financial Policy Committee  
FSA – Financial Services Authority  
FSB – Financial Stability Board  
FSCS – Financial Services Compensation Scheme  
G-SIBs – Global Systemically-Important Banks  
IAIS – International Association of Insurance Supervisors  
IBSF – Investment Bank Surveillance Forum  
ICAS – Individual Capital Adequacy Standards  
ICB – Independent Commission on Banking  
IFA – independent financial advisor  
IMAP – internal model approval process  
IMD2 – Insurance Mediation Directive  
IOSCO – International Organisation of Securities Commissions  
IRHPs – Interest Rate Hedging Products  
ISIP – Information Systems Investment Programme  
LBG – Lloyds Banking Group  
LCR – Liquidity Coverage Ratio  
LEI – Legal Entity Identifier  
LIBOR – London Inter-Bank Offered Rate  
MAD – Market Abuse Directive  
MAR – Market Abuse Regulation  
MiFID – Markets in Financial Instruments Directive

MiFIR – Markets in Financial Instruments Regulation  
MLEI – Motor Legal Expense Insurance  
MMR – Mortgage Market Review  
MoU – Memoranda of Understanding  
MTF – Multilateral Trading Facility  
ODRF – OTC Derivatives Regulators’ Forum  
OFT – Office of Fair Trading  
OTC – over-the-counter  
PBU – prudential business unit  
PPI – Payment Protection Insurance  
PRA – Prudential Regulation Authority  
PRIPs – Packaged Retail Investment Products  
PSRs – Payment Services regulations 2009  
RBS – Royal Bank of Scotland  
RCB – Regulated Covered Bonds  
RDR – Retail Distribution Review  
RIEs – Recognised Investment Exchanges  
RRPs – Resolution and recovery plans  
SAR – Special Administration Regime  
SIF – Significant Influence functions  
SIFIs – Systemically Important Financial Institution  
SPIs – Small Payment Institutions  
SSR – Short selling regulation  
UCIS – Unregulated Collective Investment Schemes  
UCITS – Undertakings for Collective Investment in Transferable Securities Directive