Annual Report 2011/12

Financial Services Authority Annual Report 2011/12

Presented to Parliament pursuant to Paragraph 10 of Schedule 1 of the Financial Services and Markets Act 2000.

This report is made by the Financial Services Authority (FSA) under the Financial Services and Markets Act 2000 (FSMA). It is made to the Treasury and covers the period 1 April 2011 to 31 March 2012.

Pursuant to paragraph 10 of schedule 1 to FSMA, the report covers:

- The discharge of the FSA's functions under FSMA;
- The extent to which, in the FSA's opinion, the regulatory objectives under FSMA have been met; and
- The FSA's consideration of matters mentioned in section 2(3) of FSMA (principles of good regulation).

It also includes the report by the FSA's non-executive committee under paragraph 4(6) of schedule 1 to FSMA.

The FSA's audited accounts for the reporting year ending 31 March 2012 are included in Section 8.

Additional material on our performance in 2011/12 including high-level indicators, can be found on our website at **www.fsa.gov.uk/pages/Library/Corporate/Annual/**

The Annual Report will be discussed at our annual public meeting on 3 July 2012.

There are further details of our annual public meeting on our website at **www.fsa.gov.uk/pages/Doing/Events/apm_2012.shtml**

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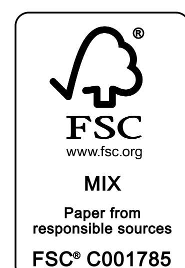

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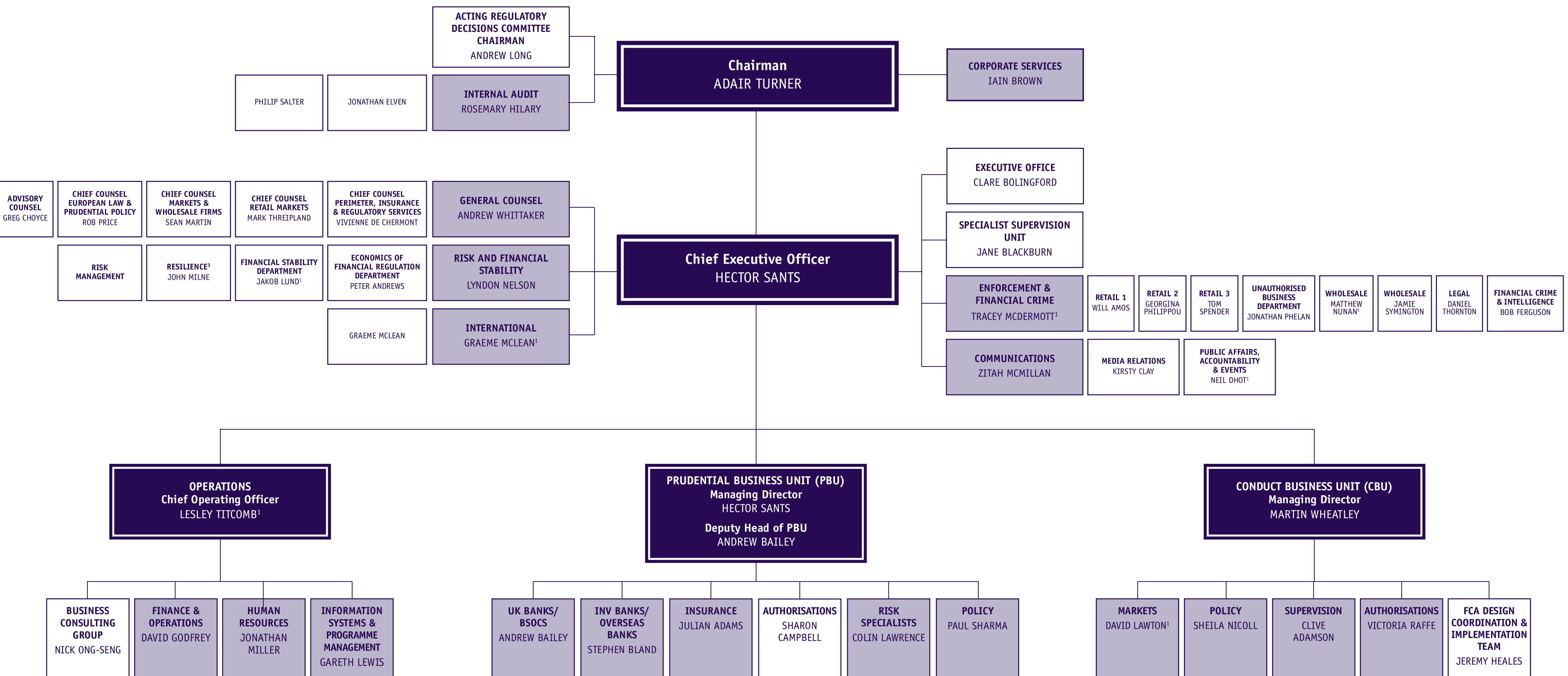
FSA
Financial Services Authority
MAY 2012
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ACTING REGULATORY DECISIONS COMMITTEE CHAIRMAN
ANDREW LONG
INTERNAL AUDIT
ROSEMARY HILARY
JONATHAN ELVEN
PHILIP SALTER
CORPORATE SERVICES
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ANDREW WHITTAKER
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ANDREW BAILEY
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JEREMY HEALES

Chairman's statement

Adair, Lord Turner, FSA Chairman

This will be the last Annual Report we publish before the creation of our two successor bodies – the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) – now most likely to occur in early 2013. Until then we will continue to be responsible for both prudential and conduct regulation, and the FCA (as the legal continuation of the FSA) will be responsible for producing financial accounts and an appropriate description of the FSA's activities for the year 2012/13. But since this will be the last report published under the FSA name, I will comment not just on the FSA's activities and performance over the last year, covered indepth within the report and in Hector Sants' statement, but over the three and a half years since I became chairman in autumn 2008.

Those years have been dominated by the aftermath of the financial crisis, which began in 2007 and intensified dramatically in autumn 2008. That crisis revealed major flaws in the regulatory approach in place in the UK and across the world, and in the intellectual assumptions which underpinned that approach. Putting right those deficiencies has been a key priority, in the UK and globally, over the last three and a half years. Within the UK, two responses in particular were essential.

- Filling the 'underlap' previously left between an inflation-targeting central bank and a regulator with a solely micro-prudential focus. This underlap resulted in inadequate focus on overall financial system developments and insufficient policy tools to guard against excessive leverage and other financial stability risks. In future this macroprudential focus will be the responsibility of the Financial Policy Committee (FPC), which has already begun work in shadow form, and will be equipped with the appropriate tools once legislation is passed. FSA staff have worked very effectively with Bank of England colleagues over the last year to support the first year of the FPC's work.

- Fixing the deficiencies of the FSA's pre-crisis micro-prudential regulatory approach. As we clearly identified in our Internal Audit report into Northern Rock (published in April 2008) and as we described again in detail in the RBS Report (published last December) our pre-crisis approach to prudential supervision was flawed, with insufficient resources devoted to the most important high-impact firms and inadequate focus on the core prudential issues of capital, liquidity and asset quality. Over the last four years, the FSA has changed radically its prudential supervisory approach. The latest steps in that transformation over the last year are described

in this Annual Report. That transformation has had to be implemented, while also ensuring a strong focus on major current financial stability risks.

In principle these vital responses to the crisis could have been delivered without structural change to our responsibilities. But in summer 2010 the coalition government committed us to what is called a 'twin peaks' model. Once the considerable challenges of implementation have been met, I am convinced that this change will deliver major benefits. The PRA will have a mandate to focus on prudential issues even when most people assume, as they did before the crisis, that prudential risks are low: and it will be located within the Bank of England, facilitating important synergies between macroeconomic and prudential analysis and insight. The FCA will have a dedicated focus on customer and investor protection challenges in both the retail and wholesale markets.

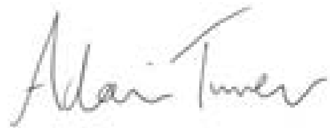
Those conduct challenges are very considerable, as our work over the last year continues to illustrate. Last year, following a legal challenge by the industry, the FSA won a crucial victory to ensure people who were mis-sold PPI would receive redress where due. Today, firms are addressing complaints and have also begun contacting people who may have been mis-sold a policy but never complained. Latest estimates put redress paid since January 2011 at about £3.5bn; the scale of customer detriment and ever-growing compensation bill sadly suggest that PPI is another chapter in the sustained litany of mis-selling scandals, which have eroded customer trust in UK retail financial services. They also illustrate, however, the ineffectiveness of the FSA's past approach to conduct regulation, which failed to intervene early enough, or far enough up the product development and marketing chain, to address problems before they produced major customer detriment. In response, therefore, and as described in this report, we are reforming our approach to conduct supervision as radically as on the prudential side, and the processes, skills and resources of the FCA are being designed to ensure a more effective approach in future.

A new more effective supervisory approach to 'early intervention' will always need to be supported, however, by the credible deterrence of potential enforcement action, and in this area too, the future authorities will build on major changes in the FSA's approach, implemented over the last five years and, as this report describes, maintained over the last year. The intensification in the FSA's enforcement effectiveness achieved over those years owed much to the leadership of Margaret Cole, who headed the Enforcement Division from July 2005 to April 2011, and who was a member of the Board from September 2010 until March this year. I would like to thank her for her great contribution to the FSA.

The major changes which have already been made to the FSA's supervisory and enforcement approach will be carried forward by our successor bodies. The work to create those successor bodies is now well advanced. In April this year, we moved to an 'internal twin peaks' model, with a clear separation between the Prudential Business Unit (headed by Andrew Bailey) and the Conduct Business Unit (headed by Martin Wheatley as FCA CEO designate). Further steps towards internal separation will be taken on 1 July this year, with Andrew and Martin reporting directly to me as Executive Chairman. The vast majority of staff are now clearly allocated to the future successor bodies: and the FSA and the Bank of England together will be in a position to implement 'legal cutover' to the new structures, and the move of the PRA staff to new offices close to the Bank, as soon as the legislation process has been completed.

Our successful transition to an internal twin peaks model, and our advanced preparation for legal separation next spring, has been led by Hector Sants. Hector had originally decided to leave the FSA in summer 2010, but was persuaded to stay to manage the FSA through a period

of major change. He has led the organisation over those two years with great energy, dedication and skill, and I would like to thank him for that, and for his leadership as CEO throughout five years of tumultuous external events and major internal transformation. I would also like to thank all of the staff of the FSA for their hard work and commitment in extraordinarily challenging times.



Adair, Lord Turner
June 2012

Chief Executive's report

Hector Sants, FSA Chief Executive

Over the past 12 months the FSA has faced a very difficult macroeconomic environment, while at the same time being required to deliver considerable structural change.

Against this challenging backdrop, our principal focus has been on ensuring that we maintain a high level of supervisory activity, as well as developing key policy initiatives to ensure the stability of firms in the system. We have also been focused on our consumer protection strategy, which seeks to actively anticipate consumer detriment and stop it before it occurs.

In our *Business Plan 2011/12*, we set out our priorities as follows:

- Maintaining ongoing supervision in a period of continued fragility in markets.
- Continuing to influence the international and European policy forums, delivering in particular the new prudential regulatory agenda.
- Implementing the current EU major policy initiatives, including Solvency II.
- Delivering on the principal national sector initiatives to improve consumer protection: the Retail Distribution Review (RDR) and Mortgage Market Review (MMR).
- Continuing to improve our operating systems and the quality of our staff.
- Implementing the government's regulatory reform agenda.

In determining the original budget for 2011/12 we were very conscious of the need to control costs, particularly given the difficult environment that firms are operating in. During the year we maintained rigorous cost control and as a consequence our actual expenditure was 3.5% less than our budget.

Part of this under-spend will be used to mitigate fee increases in the coming year. Throughout this period we also maintained our commitment to restrict our headcount while still delivering our complex and demanding agenda.

A high-level assessment of whether we have delivered against our objectives can be measured by our performance against the milestones we set out in the *Business Plan*. In 2011/12 there were 24 in total; 75% of these have been delivered in full and 25%, or six milestones have been reprioritised. Four of those were due to changes in external factors.

However, ultimately we must be assessed against our statutory objectives and outcomes. This Annual Report seeks to provide a comprehensive assessment of this performance. We review this under headings that link to our statutory objectives. As last year, we also have a separate section on delivering the regulatory reform agenda.

Regulatory reform in the UK

We have made considerable progress towards developing and implementing the new 'twin peaks' regulatory structure, which was announced by the government in 2010. This will see the prudential supervision of major banks, building societies, insurance firms and major investment firms transferred to a subsidiary of the Bank of England, the Prudential Regulation Authority. The remainder of the FSA will be renamed the Financial Conduct Authority.

In particular we successfully moved to a 'twin peaks' regulatory model within the FSA on 2 April. This was a major milestone, which will allow us to replicate as far as possible the new structure while still operating as a single regulatory authority within the current legal framework of the Financial Services and Markets Act 2000 (FSMA). It will also allow us to test and adjust the operational delivery of the future model before we cutover to the two new authorities early in 2013.

The move to twin peaks is an opportunity to drive home and further embed the move to forward-looking, proactive, judgement-based supervision. It has crystallised the change from the old style reactive approach to the new style proactive approach.

The most important change that has occurred at twin peaks, therefore, is not the introduction of a new operational framework, but the opportunity to accelerate the process of behavioural change that we embarked on when we began reforming the supervisory process in spring 2008.

We are confident that the programme to complete the transition remains on course. Our preparations are well advanced operationally, meaning we will be ready to create the two new regulatory authorities whenever the legislative timetable is complete.

Financial stability

The FSA was given its financial stability objective through the Financial Services Act 2010. Our main role in delivering this objective is as a micro-prudential regulator.

Central to the role of a micro-prudential regulator is ensuring that firms have adequate capital and liquidity. In this past year we have worked hard to ensure that this is the case. In practice, in the past 12 months, there have been no failures of any firms with systemic consequences.

As well as seeking to reduce the probability that the firms we regulate might fail, we also seek to ensure that, if they do, they do so in an orderly way that causes as little damage to the system as possible. Central to achieving this is the requirement for all UK banks to have Recovery and Resolution Plans (RRPs).

Ensuring that the major banks have credible RRPs is crucial to financial stability. For large global banks, for RRPs to work, it will be essential that there is close cooperation between the

relevant overseas authorities. The Financial Stability Board (FSB) has a programme of work to achieve this goal, which the FSA has been involved in. The last year has seen significant progress, although further work will be needed to complete this important objective, a key element of which will be the implementation within the FSB framework of a pan-European approach. The FSA has also been involved over the last year on work to develop RRPs for those non-UK Globally Systemically Important Banks (G-SIBs) for which the UK is the host regulator.

As set out in the 2009 *Turner Review* and the *Business Plan 2011/12*, the FSA also intends to require the smaller deposit-taking firms to produce RRPs. Significant work was undertaken by firms in 2011/12. Furthermore, the smaller banks also developed plans to enable rapid payout of depositors using the single customer view capabilities now required of banks in the UK.

On insurers, the prudential regulation of the largest life insurance firms was enhanced through the roll out of the Core Prudential Programme for Insurance, including business model analysis (BMA), financial risk reviews (FRRs) and stress testing. BMA work has been completed for five major life insurers, meaning that well-informed judgements on sustainability can be formed. These have provided supervisors with assurance on the extent of financial risk in the major insurers and how effectively it is managed. We have also performed stress testing exercises, including a comprehensive reverse stress testing review to provide further assurance on the resilience of the sector. The insights obtained are being incorporated into the supervisory practices of the PRA insurance division.

On supervision more generally, we set out in the *Business Plan* our aim to provide more sophisticated risk analysis across firms, risk types and asset classes. Two documents were published explaining how the PRA would use these principles to supervise banks and insurance companies, focusing on the importance of forward-looking, risk-based judgement.

Some of these changes are already encompassed in how supervisors interact with firms. Others have been built into the design of how the PBU will operate to align with the PRA.

Last year also saw the use of the Special Administration Regime (SAR) to address MF Global UK Ltd and two smaller firms for the first time. The regime has certainly provided a more effective framework than before, but it is clear that the legal framework for administration is still hampering the timely return of client assets. This is an area we and the Treasury will review in the coming 12 months.

In addition to our own actions as the micro-prudential regulator, we also deliver on this aim through supporting the wider framework for macroeconomic, fiscal and financial stability in the UK and internationally. This has been achieved through active participation in a number of different forums and initiatives and through implementing standards made internationally and in Europe.

In this regard, the Bank of England established the interim Financial Policy Committee (FPC), of which Adair Turner and I are members. The FPC is responsible for ensuring the stability of the financial system as a whole and it does this through making recommendations to both the industry and regulators. The FSA has delivered and continues to work on the recommendations it is responsible for.

Delivering market confidence

Our aim, as set out in the *Business Plan*, is 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.

Accordingly, our priorities for the past year, as set out in the *Business Plan* were:

- supervisory initiatives, including a review of our supervisory standards in relation to market infrastructures, set against a highly competitive backdrop of technological change and new trading venues;
- domestic policy initiatives, including policies that deter misconduct and deliver fair, orderly and efficient markets, through initiatives on market integrity, market cleanliness, insider dealing and market abuse, reporting systems and listing rules enhancements; and
- international policy initiatives, including on various financial instruments and commodities, plus other policies such as on short-selling and credit rating agencies.

The plan also noted that changes to the markets' regulatory regime, particularly establishing regulatory standards, are now being developed and agreed almost exclusively at an international level, and underlined the importance of influencing EU and international forums.

On supervisory initiatives, we delivered changes to the UK regulated covered bond regime that were a positive step in improving transparency and the overall quality of the regime. We continued our focus on credible deterrence through targeted enforcement action to combat insider dealing and market abuse.

In November 2011 we imposed our highest ever fine for market abuse of US$9.6m on Rameshkumar Goenka. That case, like many others in the last year, has seen us apply our new penalty framework, introduced in 2010.

Last year also saw the first public censure of a sponsor in relation to the Listing Rules. In June 2011 we censured BDO LLP (BDO) for failings while acting as a sponsor during Shore Capital Group PLC's (Shore Capital) takeover of Puma Brandenburg Limited (Puma).

The UKLA relies on sponsors to ensure that issuers meet their obligations under the Listing Rules, and it is therefore crucial that sponsors deal with the FSA in an open and cooperative manner, and perform sponsor services with due care and skill.

On international policy initiatives, we continued to reform OTC derivatives to reduce systemic counterparty risk. This enables greater transparency of OTC markets and harmonising standards for clearing houses.

We also highlighted in the *Business Plan 2010/11* the importance of MiFID, plus the need to ensure its impact is appropriate for current and future market developments.

Since the European Commission published the MiFID proposal in October 2011, we have provided active support and input into the Treasury's negotiation of the amended legislation in the European Council and Parliament. Our aim is for the proposals to promote investor protection and transparency while:

- appropriately reflecting differences in market structure across asset classes; and

- promoting competition, including by allowing appropriate access to EU markets for third country firms and investors.

The *Business Plan* also highlighted that Credit Rating Agencies (CRAs) have come under increased regulatory scrutiny because of their role in rating structured financial products in the run up to the financial crisis, highlighting the need for appropriate and consistent regulation of these agencies and activities.

We have been active in the two principal spheres of activity in relation to the regulation of CRAs: continuing to implement and embed the existing European regulatory regime and participating in policy negotiation to revise that regime. We also continued to contribute to international forums that are considering both CRA regulation and how ratings are used, most notably the IOSCO Standing Committee 6 and the Financial Stability Board.

Delivering consumer protection

In March 2010 we announced the introduction of a new consumer protection strategy, which recognises that more should be done to prevent consumer detriment by regulatory actions to make the retail market work better for consumers – with better flows of information to consumers, earlier, more robust supervisory interventions, backed up with stronger enforcement and a focus on securing redress for consumers. The delivery of this new strategy was detailed in the *Business Plan 2011/12*.

The *Business Plan 2011/12* noted the need to use business model and strategy analysis to identify firms' potential conduct risks and we have begun rolling this out for all large complex banking groups. It also outlined our intention to focus more on products and product design controls at firms, as well as the need to take preventative regulatory action in addition to seeking prompt redress and compensation when consumers suffer detriment. It also acknowledged the increasing importance of the EU's influence over conduct regulation.

The strengthening of supervisory oversight has materialised in the use of earlier interventions and increased engagement with firms on new products, ensuring they serve the needs of consumers, including:

- a review of retail structured product development and governance;

- a consultation exercise on guidance stating that traded life policy investments are not suitable for retail customers; and

- inclusion within the Financial Services Bill and MiFID II of product intervention powers that will enable the regulator in the future to take strong and effective action on products, where necessary.

In the *Business Plan 2011/12* we committed to support our supervisory approach by taking robust enforcement action in relation to the poor treatment of consumers. In particular we have taken action in relation to structured products, UCIS, Payment Protection Insurance (PPI), mortgage advice and the treatment of mortgage customers with mortgage arrears, and the protection of client money.

In the consumer protection area the FSA has historically sought, wherever possible, to avoid events generating consumer detriment above £250m or 50,000 people. There were no new events of this magnitude, however, we continued to work to minimise consumer detriment regarding the failures of funds managed by Keydata and Arch Cru.

We have also focused on the risks posed by unauthorised business, which resulted in ten injunctions being obtained to shut down schemes and freeze assets, Restitution Orders made for £32m to be returned to consumers (£27m was actually secured for distribution back to consumers), and the successful imprisonment of four share fraudsters with sentencing ranging from 2.5 to 9 years.

We have placed considerable focus on a series of domestic policy initiatives, which have allowed us to achieve structural changes in the retail financial market place. Key initiatives were the Mortgage Market Review (MMR) and the Retail Distribution Review (RDR). We also reviewed life insurance and packaged bank accounts, and how we deal with situations when conduct does not meet our expectations, including complaints handling, redress, and mis-selling.

On MMR, in December 2011 we published a Consultation Paper setting out a comprehensive package of proposals for reform in responsible lending, distribution, arrears charges and management, prudential requirements for non-deposit taking lenders and adaptations of the rules for niche mortgage markets.

Regarding RDR, a key element of our consumer protection strategy, most of the final rules are due to come into force at the end of December 2012. This represents a significant undertaking for the FSA, involving extensive consultation and research to help us finalise our policy and rules. We are now working with firms to help them prepare for implementation, including running workshops and surgeries, and publishing factsheets and newsletters.

On packaged bank accounts we have consulted widely with industry and consumer stakeholders and considered various options to improve outcomes for consumers, including preventing firms from bundling insurance policies with a bank account, new disclosure requirements and new rules explaining the steps firms must take on eligibility and suitability for these sales.

We have previously examined the way the Financial Services Compensation Scheme (FSCS) is funded and in October 2011 we announced that the FSCS Funding Model Review had begun again, as well as starting an indepth review. This will assess whether deposit takers have the systems in place to provide data to the FSCS and have started a consultation proposing that deposit takers prominently display their deposit protection arrangements.

We have undertaken further discussions with the industry and stakeholders in connection to the with-profits regime review, and a Policy Statement confirming rule changes on protecting policyholders was published in March 2012.

In addition to our domestic initiatives, we have worked on several key international policy initiatives, alongside the Treasury and other European regulators.

Delivering a reduction of financial crime

One of our statutory objectives is to reduce the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime. We achieve this through our ongoing regulation of authorised firms; participation in policy-setting bodies – including internationally; and through extensive liaison with law enforcement in the UK and overseas.

In our *Business Plan 2011/12* we set out our strategic approach to achieving our financial crime statutory objective by:

- deterring criminals from using the financial services industry;
- encouraging the regulated industry to strengthen its defences; and
- warning investors about the dangers they might face.

We continue to deliver on these through a combination of intelligence gathering, firm-specific supervision and cross-firm work.

Excluding market abuse, we fined institutions and individuals a total of £10.6m for failures to comply with our requirements for the prevention of financial crimes such as bribery and corruption, and fraud.

We also fined and banned two individuals for insurance fraud and imposed four fines and banned five individuals for mortgage fraud.

Our work also showed that, although some investment banks had completed a great deal of work to implement effective anti-bribery and corruption (ABC) controls, the investment banking sector has overall been too slow and reactive in managing bribery and corruption risk. In July 2011, we fined Willis Ltd £6.9m for failings in ABC systems and controls. These failings created an unacceptable risk that payments made by Willis to overseas third parties could be used for corrupt purposes, including paying bribes. This fine was the largest yet imposed by the FSA for financial crime systems and controls.

Delivering the FSA's operational platform

During 2011/12 we have continued to focus on the quality and capability of our staff, improving our IT infrastructure and delivering successful programmes and projects to enable us to deliver our statutory objectives and facilitate our internal preparations for forming the new regulatory structure.

The quality of our people is critical to the success of the FSA. Quality is a function of stability, training and experience. The recovery of the financial services market and two years of pay freezes in the FSA led to our staff turnover reaching 11.8% during the year, however, it did reduce to more normal levels at 9.8% by end of March.

We were also successful in continuing to recruit high quality individuals. In particular we recruited 19 newly created Head of Department roles, which are central to our relationship with firms. We also continued to provide appropriate training and development opportunities for our existing staff in conjunction with the continual phased rollout of our training and competence scheme for supervisors.

To ensure effective staff engagement with the European Supervisory Authorities (ESAs) and their growing regulatory powers, we have facilitated a number of strategic European and Global secondments within the ESAs, the European Commission, the EU Parliament, the Basel Secretariat, the International Organization of Securities Commissions (IOSCO) and other international organisations.

We have prioritised our portfolio of projects and programmes, focusing on non-discretionary pieces of work and those that are critical to delivering our objectives, enabling us to meet the additional demands of regulatory reform.

Key programme deliverables include:

- delivering a programme to implement new rules, systems and controls, and reporting requirements for firms as part of the new liquidity regime;
- implementing a strengthened regulatory regime to protect client money and assets; and
- developing systems to support e-money regulation.

We have continued to develop our technical infrastructure to meet new data collection and reporting requirements and to improve the reporting and monitoring of firms that we regulate, including:

- an upgrade of our supervisory database and risk management system;
- enhancements to the way we manage digital evidence in Enforcement investigations; and
- the launch of our Surveillance Analysis of Business Reporting System (SABRE/ZEN).

We have also continued with our enhanced work on equality and diversity following the publication of our Single Equality Scheme and Action Plan for 2010-13.

Conclusion

The continuing difficult economic conditions, coupled with delivering major structural change, have presented the FSA with a challenging year. Since it is my last Annual Report may I take this opportunity to also reflect on the last five years.

During this time we have been in the midst of the worst financial crisis in modern times. There have been many opportunities to acknowledge the flaws in the regulatory system that existed before the financial crisis. There has also been much written about these issues, but in my last Annual Report as CEO it is my chance to reflect more personally.

During the financial crisis, as I have said publicly, we gave our utmost and I do believe that in the circumstances there is nothing more the FSA could have done which would have materially changed the outcome. I also believe that without our actions it would have been worse. Furthermore, against this backdrop, to have delivered on the regulatory reform agenda is a significant achievement.

Above all, what I am most proud of is not what the FSA has achieved, nor how bad it would have been if we did not take the actions we did, but the way we have responded to how we go about regulation, our willingness to learn, and change in the face of difficult conditions and what has at times felt like relentless criticism.

Finally, I would like to profoundly thank all staff for their hard work and support throughout these difficult times.

Hector Sants

1

Structural reform of financial regulation

Introduction

In 2010, the government outlined its proposals for a new regulatory system. It announced that the FSA would be succeeded by two new regulatory authorities: the Prudential Regulation Authority (PRA) responsible for the prudential supervision of banks and insurers, and the Financial Conduct Authority (FCA) focusing on consumer protection and market regulation, creating a 'twin peaks' regulatory model in the UK.

Over the past 12 months, we have made considerable progress towards developing and implementing the new regulatory structure, as outlined in the *Business Plan 2011/12*. In particular, the implementation of a 'twin peaks' regulatory model within the FSA, has been a major milestone, which will allow us to test the future regulatory model ahead of 'cutover' to the new authorities and legal framework, the point at which the FSA ceases to exist and formally splits into the PRA and FCA.

During last year, and for the remainder of the transition programme, the FSA will remain as the single regulatory authority operating within the current legal framework of the Financial Services and Markets Act 2000 (FSMA), as amended by the Financial Services Act 2010. Our regulatory reform priorities for last year were delivered within the operational constraints of the FSA; retaining the current overall risk tolerance of the FSA, working within the existing FSA IT platform, and staying within the overall FSA headcount of 4,000.

Progress of legislative reform

During 2011 and into 2012, we continued to work closely with the government, assisting with the formulation of its plans for regulatory reform. This involved working with the Treasury, alongside colleagues from the Bank of England ('the Bank') to prepare the government publications setting out further detail on its proposed legislative reform: *A new approach to financial regulation: building a stronger system* (February 2011); and the White Paper *A new approach to financial regulation: the blueprint for reform* (June 2011).

As part of the legislative process, the proposals for regulatory reform have been subject to Parliamentary scrutiny by way of pre-legislative scrutiny and consideration by the Treasury Select Committee. In both cases, we submitted written evidence to the Committees on the proposed legislation, and they were attended by the FSA's Senior Management to provide oral evidence.

The Financial Services Bill ('the Bill') was introduced to Parliament on 26 January 2012, together with the publication of a draft Memorandum of Understanding between the PRA and FCA. Since publication of the Bill, we have been working closely with the Treasury and Public Bill Committee in the Commons as part of the process of considering detailed amendments to the Bill.

As confirmed by the draft Bill, the FCA's competition objective will go further than FSMA in that the FCA will have a specific operational objective to promote effective competition in the interests of consumers. We are making progress on designing the FCA's approach to competition, including how it will apply its tools and powers in pursuit of these new operational objectives, which will include assessing the resource and skills required to deliver this objective.

Implementing a new internal management structure

In April 2011, we replaced the Risk and Supervision Business Units with the new Prudential and Conduct Business Units (PBU and CBU) as a step towards aligning ourselves to the future regulatory structure, and ahead of making further structural changes in anticipation of the creation of the PRA and FCA. We have established the senior management structure of the PBU and CBU and refined the respective supervisory team structures. Martin Wheatley joined the FCA on 1 September 2011 as Managing Director of the CBU and as CEO designate for the FCA.

'Twin peaks' within the FSA

As we said in our *Business Plan 2011/12*, our transition plans are designed to go as far as possible towards ensuring an orderly and seamless transition to the new regulatory system in early 2013. Part of this plan was the implementation, on 2 April 2012, of 'twin peaks' within the FSA, delivering a regulatory model that will broadly replicate that to be adopted by the PRA and FCA at cutover.

Given the complexity of the task, a significant proportion of 2011/12 was spent on planning and designing the implementation of 'twin peaks'. This involved splitting the current integrated approach to supervision, making changes to our supervisory frameworks and risk assessment models, and reallocating our supervisors between the PBU and CBU.

'Twin peaks' also provides us with an opportunity to accelerate the process of behavioural change that we have been increasingly focused on since spring 2008. We provided training and support on the new supervisory approach and processes during March 2012, including communicating the new supervisory behaviours to all staff; being more forward-looking, proactive and judgement-based, with a focus on more material risks.

We also ensured that firms were kept informed of progress with the transition. From February 2012, we began a series of communications with firms to explain the impact of changes to our supervisory processes, which included speeches to industry members and 'Dear CEO' letters.

Designing and developing the PRA and FCA operating models

Last year, we took significant steps towards designing the PRA and FCA operating models. We published three documents consulting on the high-level approach that the PRA and FCA are proposing to take on firm-specific supervision. In addition, we held a number of conferences and regional events, providing the opportunity for firms, industry representatives and consumers to represent their views on the development of the PRA and FCA. We continue to engage with industry and consumers, directly and through our Panels, as we progress with developing the future regulatory organisations.

Following these publications, we have worked on the next level of strategic and detailed design for the PRA and FCA. This involved defining the future vision of the two organisations, their operating models and organisational design, which includes defining their core regulatory processes, risk appetite and resource requirements.

'Cutover' to the new authorities

Towards the end of the last financial year, we started planning and designing our transition to 'cutover', i.e. the point at which the FSA ceases to exist and formally splits into the PRA and FCA. During the course of internal 'twin peaks', we will refine our thinking and processes as the new structure gets embedded and we will further define and build the new PRA and FCA operating models.

Other financial services reforms

Over the last year, the government announced further plans for financial services reform.

In December 2011, the government published its response to the Independent Commission on Banking's (ICB) final report on recommended reforms to improve stability and competition in UK banking, which included some recommendations for the Bill. The government has confirmed that it will be implementing the main recommendations of the report – that high street banking activities are separated from investment banking activities by a ring-fence, that banks hold a higher capital buffer and that competition in the banking sector is strengthened – in full. Primary and secondary legislation relating to the ring-fence will be completed within this Parliament but separately from the Bill.

As well as assisting the office of the ICB in 2011/12 with their investigation into these proposed reforms, we have started to engage with the Treasury, alongside the Bank in preparing further legislation to implement the ring-fencing proposed in this report.

We have also assisted the Treasury in evaluating the options for transferring the regulation of consumer credit from the Office of Fair Trading (OFT) to the FCA. In January 2012, the Treasury and the Department for Business Innovation and Skills proposed that, in principle, responsibility for consumer credit regulation should be transferred from the OFT to the FCA. This means that, if a proportionate model of regulation can be identified, the FCA could be responsible for lending and other Consumer Credit Act regulated activities. Since then, we have started our work with the Treasury and others to design an appropriate regime, which we expect will be implemented one to two years following the formal creation of the FCA.

The cost of regulatory reform

As part of the progress we made implementing the regulatory reform programme during 2011/12, we incurred approximately £11.4m of direct costs in 2011/12 compared to £10.9m as originally planned, due to increased IT costs and the implementation of twin peaks within the FSA. At the current estimate, taking account of the accommodation, IT and staff transfer expenses, the full cost to the Bank and the FSA of creating the PRA will be in the region of £115m to £150m. We are confident that our programme remains on course, and we will continue to ensure that the impact of the costs of regulatory reform on firms is minimal.

Section

2

Financial stability

Introduction

Following the financial crisis, the FSA was given a new statutory objective under the Financial Services Act 2010, which required the FSA to 'contribute to the protection and enhancement of the stability of the UK financial system'.

The *Business Plan 2011/12* set out that, as the UK's micro-prudential regulator, we planned to:

- ensure that the firms we regulate are robust; and
- reduce the probability that the firms we regulate might fail or, if they do, they do so in an orderly way that does as little damage to the system as possible.

To deliver this the *Business Plan* explained that firms would be required to strengthen their capital and liquidity regimes, their systems and controls and their governance. It will also be achieved by reducing the impact of firm failure.

It will also be delivered through supporting the wider framework for macroeconomic, fiscal and financial stability in the UK and internationally. This will be both through active participation in a number of different forums and institutions, and implementing standards set internationally and in Europe.

This chapter shows how we delivered on the *Business Plan* aims, set out as:

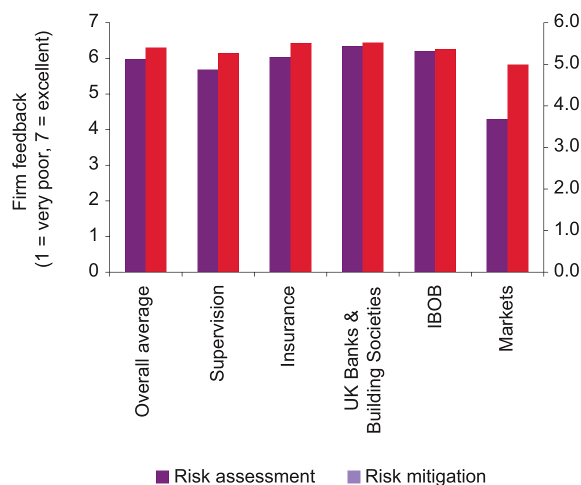
- supervisory initiatives, including risk modelling, a Core Prudential Programme for insurers, new special administration and client assets regimes, plus new oversight powers;
- domestic policy initiatives, including recovery and resolution plans and credit unions;
- international policy initiatives, including governance reviews, capital and liquidity frameworks; and
- other policy work, including group-wide supervision of internationally active insurance groups, plus lessons learned from our market-wide exercise.

Key metrics

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

Supervisory effectiveness

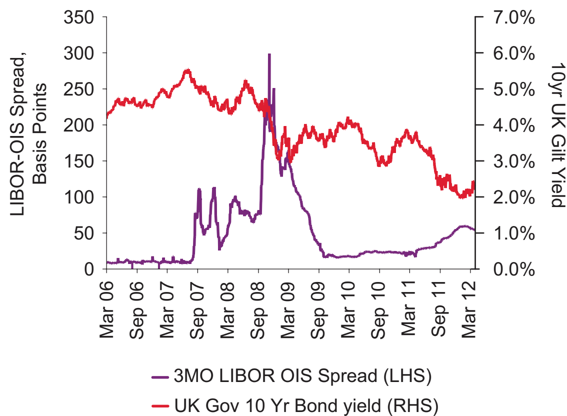
Chart 1: Firm feedback on the quality of FSA supervisory risk assessments



The overall average scores have remained relatively unchanged since the beginning of 2011. With regards to risk assessment, Supervision has seen an improvement in average score from 4.3 to 4.9, whilst Markets has seen a significant deterioration from 5.1 to 3.7, taking it below the neutral score of 4. Markets is the lowest scoring Division for risk assessment. In terms of risk mitigation, the largest movement in scores occurred in the Insurance division which fell from 5.8 to 5.5. The average score in the Markets division fell slightly from 5.2 to 5.0. As with the risk assessment category, Markets is the lowest scoring division.

Measures of financial stability

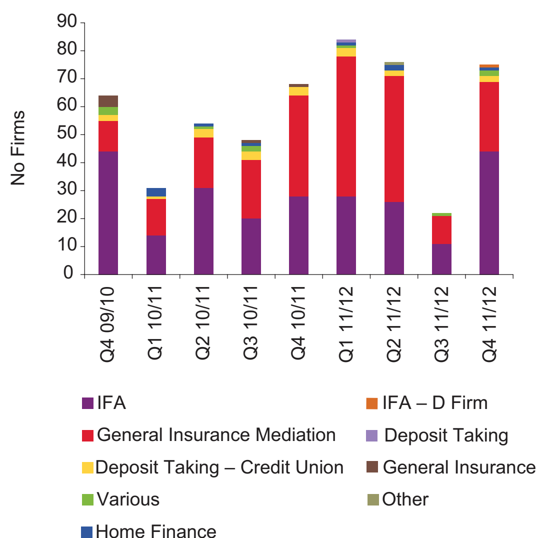
Chart 2: Cost of credit



The three month Libor-OIS spread is a measure of perceived counterparty risk in short-term inter-bank funding markets. It was an upward path since April 2011, as fears of contagion from the euro crisis have pushed up LIBOR rates, although the ECB's LTRO operations have helped ease concerns (and LIBOR-OIS spread) this quarter.

The 10-year gilt yield represents the cost of long-term funding for the UK government. Falling growth and interest rate expectations, the UK's status as a safe-haven country, and the impact of QE have all benefitted gilt prices, pushing the 10-year yield to historic lows – reaching just 1.97% in January 2012, and 2.2% by the end of March 2012. However, given uncertainty about the macro outlook, there is a high possibility of rapid reversal.

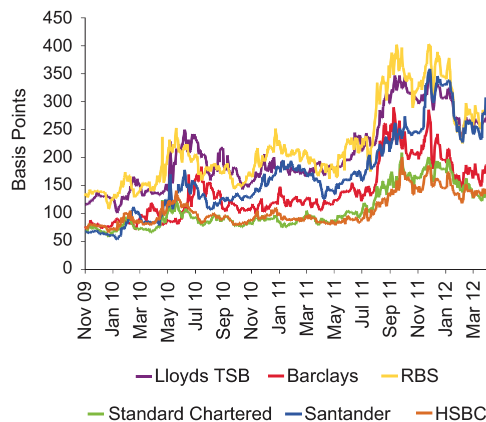
Chart 3: Number of failures by firm/sector



The total number of firm failures this quarter has increased from 22 to 75. The variance in the number of defaults arises mainly from internal matters such as resource arrangements and a concentration on resolving a larger proportion of older claims which generally take longer.

Two deposit taking credit unions were declared in default, Handsworth Breakthrough Credit Union and Hull East of the River Credit Union.

Chart 4: Major UK Banks – CDS Spreads – five year Senior Debt



Banks' CDS spreads are an indication of market perceptions of credit risk. The start of the year saw some narrowing but spreads have again begun to widen towards the end of March 2012, due the deterioration in the UK and global macro outlook. The ongoing Euro Area crisis is affecting UK banks' CDS. Banks with greater exposure to developing markets (HSBC, SCB) have generally been less affected, although their CDS premia began to rise as well as it became clear that the Euro Area's problems would damage global growth. Santander UK's CDS premium has now risen above its UK peers, in line with growing concerns over the Spanish economy, banks and Sovereign finances.

Establishment of the Financial Policy Committee

In February 2011 the Bank of England ('the Bank') established the interim Financial Policy Committee (FPC) with Adair Turner and Hector Sants among the members. The FPC looks across the economy at macro-prudential issues that may threaten economic and financial stability, while FSA insights helped the FPC determine more feasible recommendations. The FPC has issued a number of recommendations to the FSA, and the FSA reports back to the FPC on its implementation of those recommendations. The FPC publishes records of its meetings and a half-yearly financial stability report on the Bank's website.

We have participated in a number of international forums, and continue to work with the Financial Stability Board (FSB), including coordinating work on assessing and mitigating global threats to financial stability. This has remained a significant work stream for us as part of developing recovery and resolution plans for deposit-taking organisations.

In 2011 the EU established the new European System of Financial Supervision, comprising:

- the European Systemic Risk Board (ESRB);
- the three European Supervisory Authorities (ESAs);
  - the European Banking Authority (EBA);
  - the European Insurance and Occupational Pensions Authority (EIOPA);
  - the European Securities and Markets Authority (ESMA);
- the joint committee of the ESAs; and
- the competent or supervisory authorities in the member states.

The ESAs have decision-making powers over national supervisory authorities. Because the EU has an ambitious agenda for regulatory reform in the financial sector it is important we have a strong voice in these new authorities. We have senior representation on all three ESAs.

In addition, the ESRB was established as an independent body responsible for macro-prudential oversight of the EU's financial system. We have been active in the ESRB's work to date, with Adair Turner attending the General Board, and other FSA staff attending the Advisory Technical Committee and its working groups. As well as regularly exchanging views on risks and vulnerabilities in the EU's financial system, the ESRB has published three public recommendations on specific risks: lending in foreign currencies, US dollar-denominated funding of credit institutions and the macro-prudential mandates of national authorities.

Supervision

Following on from the *Business Plan 2011/12*, which set out our aim to provide more sophisticated risk analysis across firms, risk types and asset classes, two documents were published to explain the high-level principles that the PRA would use to supervise banks and insurance companies, focusing on the importance of using forward-looking, risk-based judgement in supervision. Over the past year, prudential supervision in the Prudential Business Unit (PBU) has continued to make changes to its processes and focus, to begin to align with the PRA principles.

Some of the changes already made encompass how supervisors interact with firms, including a focus on a smaller number of key actions that firms need to work on; delivering these messages directly to the boards of firms, plus more senior level engagement to support supervisors. Significant work has also gone into considering how the PRA and FCA will interact under the new legal regime, including reorganising prudential and conduct supervision teams within the FSA from April 2012 to reflect as closely as possible the future legal responsibilities of the PRA and FCA.

Developing supervisory tools

Risk modelling

As set out in the *Business Plan*, our aim was to build a robust risk, modelling, analysis and infrastructure model. We developed strategic solution architecture and prototype technical infrastructure with revised models and risk analytics tools, together with data and model management capabilities. Additionally, a new development platform was installed at the Bank – the first such installation of its type.

Core Prudential Programme for Insurance

The prudential regulation of the largest life insurance firms was enhanced through the roll out of the Core Prudential Programme for Insurance, including business model analysis (BMA), financial risk reviews (FRRs) and stress testing. BMA work has been completed for five major life insurers, meaning that well-informed judgements on business model sustainability can be formed. FRRs deliver indepth reviews on the key areas of financial risk for insurers, including technical provisions, asset quality, asset liability management, liquidity and risk transfer arrangements, as well as assessing standards of financial risk management and capital planning. These have provided supervisors with assurance on the extent of financial risk in the major insurers and how effectively it is managed. We have also performed stress-testing exercises, including a comprehensive reverse stress-testing review to provide further assurance on the resilience of the sector. The insights obtained are being incorporated into the supervisory practices of the PRA insurance division.

Special Administration Regime

Reflecting an increased strategic focus on recovery and resolution work, the Special Administration Regime (SAR) was used for the first time for the orderly winding down of three investment firms: MF Global UK Ltd, Pritchard Stockbrokers Ltd and Worldspreads Ltd. It was introduced by the Treasury in February 2011 following the collapse of Lehman Brothers. It sets clear objectives for the administrator, including the swift return of client money and assets and timely engagement with market infrastructures. It also allows us (if required) to direct the administrators to prioritise one or more of the objectives if it is in the interests of financial stability or maintaining public confidence in the markets.

MF Global UK Ltd entered the SAR on 31 October 2011 following a period of stress on the business precipitated by market concerns about its liquidity position. This followed the parent firm, MF Global Inc, filing for Chapter 11 bankruptcy in the US for similar reasons.

Under the SAR, we worked closely with KMPG – MF Global UK's appointed administrators – to ensure the swift return of client money and assets. We have also kept in contact with global regulators and the various international firms and stock exchanges involved. KPMG announced an interim distribution process for client money, starting on 8 December 2011. On 3 February 2012, KPMG stated that they are to make a first distribution of 26 cents per US dollar of an agreed claim for client money. Further distributions are envisaged, but have been hindered by uncertainty about who is entitled to claim a share of the client money pool, and claims by parties that their funds should have been separated from the overall total fund. Also, differences in US and UK insolvency law have led to different timelines for the return of client assets and money. In May 2012, KPMG announced the recovery of almost $1bn (representing approximately 90% of the total outstanding) of the segregated MF Global UK client money pool.

The SAR has been used subsequently for Pritchard Stockbrokers Ltd and Worldspreads Ltd, who entered the SAR on 9 March 2012 and 18 March 2012 respectively. We are working with the relevant special administrators to review the client cash holding positions and to ensure that returns of client money are made as efficiently as possible. Regarding Pritchard, we helped facilitate the sale of the client bank to another firm of stockbrokers, which will help mitigate further consumer detriment through the recommencement of trading outside the pooled event.

Client assets

The *Business Plan 2011/12* set out that the protection of client money and safe custody assets (client assets) would remain a regulatory priority. We committed to an intrusive regulatory and supervisory approach, to increase our oversight of the UK market through enhanced reporting and notification requirements for firms, and to continue to raise awareness of CASS (client assets sourcebook) among firms, their senior management and their clients. We have made progress against these commitments by:

- increasing the specialist regulatory and supervisory resources dedicated to client asset protection in the FSA;
- conducting over 50 dedicated client asset visits to firms, in addition to approximately 130 desk based reviews of firm specific and thematic issues; and
- publishing eight policy papers strengthening the CASS regime.

There has been increased awareness and understanding of client assets in the industry; but we still see fundamental and significant failures in the ability of some firms to properly identify and segregate clients' money and assets.

During the course of the year we imposed two penalties on firms for CASS breaches. We also fined and banned one individual for client money failings.

Improving our oversight

The *Business Plan* set out our strategy to increase our knowledge and oversight of the UK market through enhanced reporting and notification. We classified all investment firms holding client assets into small, medium or large from a CASS perspective based on the size of their holdings, and classifications will be revisited annually. This places more focus on the potential risk posed by different firms, and the impact they could have on clients and the market should they fail.

We have introduced a new operational oversight function (the 'CF10a') for all medium and large CASS firms. This ensures that a single individual is responsible for overseeing the operational effectiveness of that firm's systems and controls for compliance with CASS, and for reporting on these matters to the firm's governing body. This also gives the FSA a primary point of contact in the firms holding the most significant amounts of client assets.

Another fundamental change we made was to improve our market oversight by implementing a dedicated regulatory return for investment firms holding client money or assets – the Client Money and Assets return (CMAR[1]). This provides us with a wealth of data relating to firms' holdings of client assets and allows us to:

- make regulatory interventions in relation to client assets on a timely, firm-specific or thematic basis; and
- better analyse trends across sectors or the market as a whole.

Working with auditors

We introduced new rules that state to firms what we require of their external auditors when producing client assets reports, and increasing the accountability within firms and their auditors. The Auditing Practices Board also revised its guidance to auditor firms on the client asset reporting. This increased focus should drive improvements in both the quality and consistency of auditor client assets reporting, and over the last year we already saw some positive evidence of this change.

LBIE Supreme Court client money appeal

The Supreme Court gave judgment on 29 February, in an appeal case relating to Lehman administrators' approach to the return of client money. This case is of fundamental importance to how client assets are protected in the UK.

The case concerned whether all clients should be entitled to assert that money received by Lehman was held on trust for them, and whether the client money pool extended to money in the firm's house accounts provided this could properly be identified as client money. The decision reached by the Supreme Court was the outcome we had argued before the Court of Appeal; in line with how the client assets regime has been applied, and resulting in securing protection for all clients of Lehman.

1 We receive these returns monthly for all CASS large and medium firms, with mid-year notification requirements for all CASS small firms. This ensures that we maintain oversight of any market changes, without imposing a disproportionate burden on firms.

Domestic policy initiatives

Recovery and resolution plans

The Financial Stability Board (FSB) published its *Key Attributes of Effective Resolution Regimes for Financial Institutions* during 2011. The FSB has set out a programme of work to remedy the problem of 'too important to fail' among the major prudential institutions (G-SIBs), which has been endorsed by the G20 ministers.

In the UK, we have continued to develop Recovery and Resolution Plans (RRPs) for the major UK Banks. A key part of this work is to ensure cooperation with the main overseas authorities from countries in which those banks operate. This is vital to the success of the work on RRPs, as a resolution plan has to be executed simultaneously across these jurisdictions. Much of this work takes place in so-called crisis management groups, and we have been involved over the last year on work to develop RRPs for those non-UK G-SIBs for which the UK is the home regulator.

As set out in the *Turner Review* and the *Business Plan*, we intend to produce RRPs for the smaller deposit takers based in the UK, and work was carried out in 2011/12 on RRPs for banks below the tier of G-SIBs. Work was also undertaken by firms in 2011/12 to develop plans to enable rapid payout of depositors using the single customer view capabilities now required of banks in the UK.

Northern Ireland Credit Unions

Following a decision by the government and the Northern Ireland Executive, responsibility for regulating Northern Ireland Credit Unions (NICUs) transferred from the Department of Enterprise, Trade and Investment in Northern Ireland (DETI) to the FSA. As part of this, Consultation Paper 11/17 was published in August 2011, and a Policy Statement and near-final rules were published in December 2011. This transfer took place on 31 March 2012.

We worked closely with the Treasury and DETI on the legislative amendments and proposed changes to FSA rules needed to implement the transfer. We put in place a transition plan to allow a smooth integration to our current supervisory approach, which includes ensuring that our contact centres will be able to provide information and guidance to affected firms and consumers.

This involved:

- making necessary additions and changes to our IS systems, business processes and supervision resources, as well as providing briefings for our contact centres and developing a NICU section on the FSA website;
- arranging two series of road-show events for NICUs – the first to explain the consultation proposals (September-October 2011) and the second to explain the final rules and grandfathering arrangements (January-February 2012);
- providing necessary information regarding the infrastructure to be in place to begin supervising NICUs from 31 March 2012;
- recording information received from NICUs for grandfathering by 31 March 2012; and
- identifying sector issues and potentially problematic NICUs for initial supervision work from 31 March 2012.

Governance

We have continued to develop the ideas, contained in our Adair Tuner's foreword to the RBS report, of potential ways to address the risk-reward trade-offs for those who run banks so that they place a greater emphasis on avoiding downside risks. In addition, we have looked at how the significant influence function roles should be split between the PRA and the FCA in light of the Bill text.

The *Business Plan 2010/11* included a commitment to implement PS10/15, *Effective corporate governance – significant influence controlled functions and the Walker Review*. A key element was the introduction of nine new 'controlled functions', which individuals must have FSA approval to perform and will help to ensure that firms have appropriately qualified, capable and experienced individuals in key positions to deliver this. Our intention was for firms to submit to us via our Online Notification and Applications system (ONA) details of those individuals who will be transferring across to the new controlled functions. However, there was a considerable programme of work being undertaken on the ONA system, so we were unable to make the changes necessary to process applications for these new functions. We therefore decided to postpone the implementation of those elements of PS10/15 that were dependent on the ONA system.

Remuneration

We have sought to apply the Remuneration Code ('the Code') in a proportionate manner, taking account of the nature, size and complexity of firms within scope. Our monitoring and enforcement of the Code continued into 2012, amidst widespread interest in remuneration in the financial services sector. Our principal objective remains to ensure that firms have remuneration policies and practices that are consistent with and promote effective risk management.

In response to industry feedback, throughout 2011 we published guidance on important aspects of our remuneration framework:

- In June 2011, we extended the transitional period allowing unlisted firms more time to comply with the requirement to pay a portion of bonuses in shares or other non-cash instruments.
- In August 2011, we published a set of frequently asked questions (FAQs) covering a wide of range of issues relating to the Code.
- In October 2011, we published guidance on the practice of offering buy-out awards. We also published a 'Dear CEO' letter setting out our supervisory approach for the coming remuneration round, and how we would carry this out in a proportionate manner.

Between Autumn 2011 and early 2012, in line with the 'Dear CEO' letter, we reviewed compliance with the Code by the largest and most significant firms. This is the third consecutive year in which we have undertaken these reviews and, as before, they focused on several pivotal principles of the Code, including:

- the robustness of firms' governance arrangements regarding remuneration;
- whether a firm's remuneration practices might undermine its ability to preserve a sound capital base;
- the extent to which bonus pools are adjusted to take account of current and future risks;

- the extent to which firms' remuneration policies and practices are aligned with their risk appetite and do not encourage behaviours that could damage the long-term health of the firm; and
- whether the firm has implemented sufficiently robust mechanisms to enable it to reduce deferred unvested bonuses in appropriate circumstances.

Shadow banking

It was apparent during the 2007/8 crisis that risks similar to those created by banks, or bank-like risks, could be replicated by non banks and by transactions beyond the regulatory perimeter. This is referred to as 'shadow banking', which can arise from the activities of securities firms, structured investment vehicles, conduits, money market funds and also some hedge funds and finance companies, as well as the non deposit-taking activities of banks. As this type of finance is significant in several financial centres, and given the connectivity between markets, the G20 called on the Financial Stability Board (FSB) to coordinate work internationally. As a result, the FSB is to design a set of measures for countering the potential for shadow banking to generate systemic risk.

The FSA is closely involved in this work; Adair Turner co-chairs the FSB's Task Force on Shadow Banking, as well as leading work to identify appropriate regulatory responses through its Standing Committee on Regulatory Cooperation. There are five components to this programme: (i) banks' engagement with shadow banks; (ii) money market funds; (iii) identification of other entities or forms of 'non bank' banks; (iv) incentives in securitisation markets; and (v) the role of secured lending and repo markets. This work is aimed at ensuring that risks are given an appropriate regulatory treatment; it does not seek to prevent shadow banking nor inhibit non-bank intermediation more generally.

Hedge Fund Survey

Hedge funds have the potential to pose systemic risks to financial stability if they are individually very large or leveraged.

We have continued to assess the potential risks to financial stability emanating from hedge funds. This was achieved through our twice-yearly Hedge Fund Survey and Hedge Fund as Counterparty Survey.

The Hedge Fund Survey helps us better understand hedge funds' use of leverage, footprints in various asset classes, scale of any asset liability mismatch and credit counterparty risks. It is complemented by the Hedge Fund as Counterparty Survey, which is a key tool in assessing bank and prime broker credit exposure to this segment.

The latest surveys were conducted in September/October 2011, and we published the results in Q1 2012. We also presented the analysed results to senior management, supervisors of alternative asset management firms and some banks to help in their reviews.

Internationally, we continued to work with other national regulators to promote the collection of comparable hedge fund data. In particular, the US Securities and Exchange Commission's new reporting form (Form PF) includes many of the types of information collected through the our Hedge Fund Survey. We continue to engage with the Alternative Investment Fund

Managers' Directive (AIFMD), which will require regular reporting obligations for all alternative investment fund management sectors, including hedge funds. We are also working closely with the International Organization of Securities Commissions (IOSCO) and other national regulators to ensure that we can more clearly identify global risks through a consistent and proportionate international approach to systemic risk data collection for hedge funds.

International policy initiatives

EU Banking Capital Frameworks

Basel III

We are active in the Basel Committee on Banking Supervision (BCBS). We chair, or co-chair, the Leverage Ratio Group, the Macroprudential Supervision Group, the fundamental review of the Trading Book, plus contribute to the work of the Committee across all its working groups. In 2011 we participated in work the BCBS undertook on trade finance exposures to Low Income Countries.

We have played a significant role in reviewing the capital standards for trading activities with the aim of significantly strengthening the trading book boundary, addressing the failure of internal models to capture the full range of trading risks, ensuring trading books capital standards and liquidity horizons are appropriate and significantly improving valuation standards so that capital resource measures are accurate.

In relation to G-SIBs, the BCBS published its final rules text on the G-SIB framework in November 2011. From January 2016, banks that are determined to be G-SIBs will be subject to a common equity surcharge of between 1% and 2.5% of Risk Weighted Assets, depending on their systemic importance. We were heavily involved in this work and co-chair the group that undertakes the relevant analysis and policy development.

CRD IV

We have, in partnership with the Treasury, been participating in European Commission working groups and European Council meetings to progress negotiations on the proposed new Capital Requirements Regulation and Directive (collectively know as 'CRD IV'), which will set the prudential standards for banks, building societies and investment firms in the EU. We have analysed and assessed the implications of the proposals for the UK prudential regulatory regime and have helped to clearly articulate UK views in European discussions.

Pillar 2

The *Business Plan 2011/12* discussed the need to enhance risk-identification and management processes and put in place an enhanced risk-management framework. We have implemented the requirements on Capital Planning Buffers, stress testing and reverse stress-testing and reviewed firms' submissions to us. These are new key elements of our forward-looking prudential framework. This means that UK firms need to identify and hold firm-specific capital buffers that are informed by stress-testing and reflect their individual circumstances. This has supported our efforts to enhance the resilience of the UK banking sector.

We have further taken steps to require firms to adequately capitalise risks that are not captured in Pillar 1. Because of better risk-assessment methodologies and the extra resources to assess firms, UK credit institutions are subject to more comprehensive capital requirements. This supports UK firms in being more resilient to downturns and to continue to perform their

function of providing finance to real economy. In the EU bank recapitalisation assessment, it was found that participating UK banks did not require further recapitalisation.

In addition, we have complied with new European requirements on reaching joint decisions on firms' capital requirements within the colleges' framework and have been assessing how to implement Pillar 2 in the context of the new EU legislative requirements implementing Basel III and the new PRA supervisory approach and priorities.

Building societies and mutual insurers

The *Business Plan 2011/12* noted that a weakness of the mutual model is its inability to raise core tier 1 capital in times of stress. Under the current EU Capital Requirements Directives, there is no core tier 1 instrument that the sector has found to be commercially viable. Building societies can issue, and have issued, profit participating deferred shares (PPDS) as a core tier 1 instrument, but these are considered appropriate for distressed situations only.

Our work focused on the new proposed capital framework in CRD IV, in particular regarding core tier 1 capital, on the basis of the recognition in Basel III that the mutuals' capital framework needs specific treatment. Working with the Building Societies Association (BSA), we supported the Treasury in European negotiations to make specific provisions within CRD IV to better accommodate the UK building society model, without compromising the quality and effective going-concern loss absorbency of Common Equity Tier 1 (CET1) capital.

Pilot scheme

Poor governance was the root cause of some building societies' problems during 2008/9. With this in mind we launched a pilot scheme in 2010 to assess board effectiveness at building societies.

Following this scheme, from 2011 board effectiveness assessments have been rolled into our normal work programme and during the last year we carried out assessments at a further ten building societies. The assessments enabled us to make recommendations, where appropriate, for improvements to governance structures and processes and also regarding board composition.

We have been able to obtain a much better understanding of governance structures and processes, including how significant decisions are made, as well as the contribution of individual directors.

EU Insurance Capital frameworks

Solvency II

Consultation with UK firms

In November 2011 we published Consultation Papers CP11/22 and CP 11/23.

- CP11/22 set out our approach to transpose the prudential elements of the Solvency II Directive for 1 January 2013.

- CP11/23 presented proposals for changes to our rules and guidance relating to the operation of unit linked and index linked insurance business.

The Treasury also released its Consultation Paper on proposed amendments to make UK legislation compliant with Solvency II. All three consultations closed on 15 February 2012.

Developing European policy for Solvency II

We continued to contribute to the development of Solvency II policy (Levels 1, 2 and 3 of the legislation). Hector Sants sat on the EIOPA Management Board and the Board of Supervisors. Julian Adams became Chair of the EIOPA Review Panel in May 2011. We hold the chair of the Internal Models Working Group and Equivalence Committee, participating in drafting legislation via our representation throughout EIOPA. In November 2011 we held a round table to brief the industry on EIOPA's consultation papers on the Own Risk and Solvency Assessment (ORSA) and reporting.

Detailed policy negotiations are ongoing and implementation dates have changed. In October 2011 we revised our planning assumptions in light of the discussions in Europe about splitting the implementation dates for Solvency II, referred to as 'bifurcation'. Our current assumption is:

- 1 January 2013 is the date at which the responsibilities of supervisors and EIOPA come into effect (i.e. transposition of the Directive would have to be complete by 1 January 2013); and

- 1 January 2014 is when the Solvency II requirements would be switched on for firms.

Speaking to the industry

Discussions with firms and industry groups were ongoing. The complexity and lead times involved for internal model development meant that we focused efforts on those firms that will be submitting an application to use an internal model.

In April 2011 we held a full day conference to brief those people responsible for implementing Solvency II at their firm. We explained that we will adopt a risk-based approach in the resourcing we would devote to internal model firms in the pre-application phase. We will focus on the firms with the greatest market share – those that we have always regarded as having the highest potential impact on our objectives will receive greatest intensity of review.

In October 2011 we undertook a survey of all firms affected by Solvency II to understand the kind of approvals they intended to apply for and the activities they expected to undertake. We received over 300 responses, a completion rate of just under 80%. This has helped us plan the work required in the run-up to implementation.

In November 2011 we held a further briefing for internal model firms, where we updated them on developments in our implementation approach, particularly as a result of the split and following our survey to firms in October. Because of bifurcation and changes in the policy timeline, we agreed individual submission slots for internal model firms. Additionally, in February 2012, we held a briefing for the same group of firms on the materials and information available to help them make their internal model submission from March 2012 onwards.

We participated in a number of key industry events and in December 2011 we shared our stance with firms on how they could use their Solvency II models to meet obligations under the existing

Individual Capital Adequacy Standards (ICAS) regime, removing the need for parallel running of two different regulatory capital models. We also continued our work with smaller insurers, holding a seminar targeted at them in October 2011.

Technical capabilities

We have developed technical tools and undertaken systems development necessary for the application process for internal models. This also included designing and delivering technical training to our staff on both Solvency II itself, and how it is developing, and our new regulatory processes. From April 2011 to March 2012 we delivered over 95 courses training over 400 FSA staff on key aspects of Solvency II.

Liquidity regimes

As we said in our *Business Plan 2011/12*, last year we moved our focus from developing domestic policy to implementing our regime through our intensive supervisory approach.

Our supervisors, with the support of our risk specialists, have been carrying out indepth supervisory liquidity reviews with firms to assess their compliance with our qualitative and quantitative liquidity rules within the framework of our Individual Liquidity Adequacy Standards (ILAS) process. The outcome of this has been setting individual liquidity guidance (ILG) for firms, replacing either the 'backstop ILG', put in place for our largest banks and building societies in June 2010, or the liquidity limits imposed by prior regimes.

In taking a risk-based approach to scheduling these supervisory liquidity reviews, we estimated we would conduct 105 reviews for 1 April 2011 to 31 March 2012 and we made good progress towards achieving this target. As at 31 December 2011, approximately 70 reviews had been completed.

In 2011, we also rolled-out the final phase of our enhanced business intelligence toolkit to supervisors. This marked the completion of an extensive information technology programme, which delivered enhancements to a number of systems, including business intelligence and GABRIEL, our online reporting system.

We continued to participate in EU discussions on introducing the proposed liquidity quantitative standards: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Requirement (NSFR), which are part of the liquidity reforms within the 'CRD IV' legislative package. With the data we collected from our largest firms, we engaged with Basel and the EBA working groups on a number of initiatives designed to assess the impact of the two new standards before they come into force. This included the EBA's liquidity review in March/April 2011 and the ongoing 'Basel III Monitoring Exercise', involving collecting data on liquidity, capital, leverage, etc, on a twice-yearly basis.

In January 2012, we invited all firms covered by the scope of CRR/CRD IV to participate in a year-long voluntary LCR monitoring exercise for the EBA, and started work with them to improve the quality of their LCR data submissions in preparation for mandatory LCR reporting.

Influencing governance reviews

As set out in the *Business Plan*, we remain committed to improving standards of governance across the financial services industry. During 2011/12 we were again actively involved in influencing the international agenda on governance. We have been keen to improve standards while avoiding over prescription and a one-size-fits-all approach. Some of the proposals in

the European Commission's green paper, *Corporate Governance in Financial Institutions*, are included in both the draft CRD IV and MiFID review texts. We are working to encourage a consistent approach in these directives for firms affected by both. Within the EBA we have been involved in the internal governance guidelines published in September 2011 and guidelines on the assessment of members of the management body. In ESMA we have contributed to a review of the compliance function.

On insurance, the principles and standards covering governance were considered as part of the IAIS's review of the Insurance Core Principles and our consultation on Solvency II set out how we would implement the Directive's governance requirements.

Other policy work

In the international field, in addition to the work we are doing in FSB, IOSCO, BCBS and the new European authorities, we continued our engagement in the technical work of the International Association of Insurance Supervisors (IAIS). Revised insurance core principles (a globally accepted framework for the supervision of the insurance sector) were adopted at the IAIS's Annual Meeting in October 2011. The IAIS has also developed a common framework (ComFrame) for the group-wide supervision of internationally-active insurance groups (IAIGs). ComFrame aims to interpret the insurance core principles in relation to IAIGs with a view to:

- make group-wide supervision more effective and more reflective of actual business practices;
- establish a comprehensive framework for supervisors to address group-wide activities and risks, set grounds for better supervisory cooperation, and allow for a more integrated and international approach; and
- fostering global convergence of regulatory and supervisory measures and approaches.

A first 'Concept Paper' was published for consultation in July 2011.

Market Wide Exercise (MWE)

We led the design and delivery of the UK Financial Authorities' sixth MWE on 22 November 2011. In total, 87 firms (including the authorities) took part, involving almost 4,000 people.

The scenario used was a cyber attack on the financial sector, against the backdrop of the Olympic Games. The participants were able to test their resilience to deal with this scenario and whether their preparations for maintaining daily business activity during the Olympic Games was sufficient.

All the participants agreed that the scenario delivered important learning points, these were summarised in the MWE Report published on the authorities' website (www.fsc.gov.uk) on 3 February 2012 and discussed at a follow-up conference on 23 February 2012.

Section

3

Delivering market confidence

Introduction

One of our statutory objectives is to maintain market confidence in the UK's financial system. The *Business Plan* highlighted that it is our aim 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.

The *Business Plan* pledged that our attitude was to use risk-based approaches, designed to ensure that in achieving these aims we consider competition and innovation, while making sure that we create a strong and credible policy to deter market participants from committing financial crime.

However, the plan also noted that changes to the markets' regulatory regime, particularly establishing regulatory standards, are now being developed and agreed almost exclusively at an international level, and underlined the importance of influencing EU and international forums.

This chapter sets out how we delivered on the *Business Plan* aims, set out as:

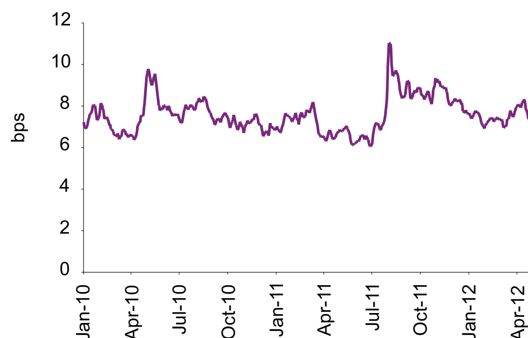
- supervisory initiatives, including a review of our supervisory standards in relation to market infrastructures, set against a highly competitive backdrop of technological change and new trading venues;
- domestic policy initiatives, including policies that deter misconduct and deliver fair, orderly and efficient markets, through initiatives on market integrity, market cleanliness, insider dealing and market abuse, reporting systems and listing rules enhancements; and
- international policy initiatives, including on various financial instruments and commodities, plus other policies such as on short-selling and credit rating agencies.

Key metrics

We have outlined some of the ways in which we assess the quality of UK markets in:

- FTSE 100 Time weighted spreads (Chart 1);
- FTSE Volatility measures (Chart 2); and
- measures of market cleanliness, discussed later in this chapter.

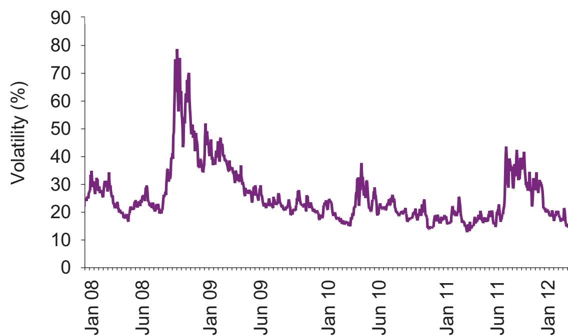
Chart 1: Bid-offer spread of FTSE 100 securities on the London Stock Exchange (5-day moving average)



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 spread has been around 7.5 basis points, with a particular spike beginning in August 2011. Since then, spreads have improved but have not reduced to prior levels. The widening in spreads has largely been driven by increased uncertainty for the global macroeconomic environment; for example, heightened concerns for the Eurozone sovereign debt crisis, as well as the credit rating downgrade for US Treasury Bonds in August. This uncertainty has fed through into asset price volatility – as also demonstrated by the VFTSE – which reduces the confidence with which market participants quote buy and sell prices, leading to wider bid-offer spreads

Chart 2: Market volatility



VFTSE is the market's expectation of 30-day share volatility through options prices. The higher the figure the more volatile the stocks included in the FTSE 100. This measure of dispersion indicates how risky FTSE 100 shares are perceived to be. A VFTSE below 20% has historically been associated with periods of market stability.

The level of the UK Index continued to fall since Christmas, showing a marked improvement but also continuing to reflect the serious issues in the Eurozone. However, it is not clear that a sustained recovery is in progress and this is reflected in the status of the VFTSE at the end of the last quarter at just below 20%.

Supervision

Delivering our intensive supervisory approach in markets

The *Business Plan* highlighted that the market infrastructure environment is in a state of change, driven by market and regulatory responses to the financial crisis, technology, plus changes at a European level. Following the implementation of the Market in Financial Instruments Directive (MiFID) in 2007 and the rapid pace of technological change, a number of new trading venues have come into existence. However, we are now seeing an increasing tendency towards consolidation among trading infrastructures. In 2011/12 our supervisors were involved in assessing the effects of various potential infrastructure consolidations on the ability of the entities to meet their ongoing recognition or authorisation requirements.

As part of our ongoing review of our supervisory standards in relation to market infrastructures, in 2011/12 we:

- Published proposals in CP11/19 to amend the Financial Resources Requirement (FRR) for Recognised Bodies (RBs). This is part of our wider review of Part 18 FSMA, which will lead to amendments to the Recognition Requirements (REC Sourcebook) following agreement on the Financial Services Bill.

- Issued guidance in January 2012 on counterparty credit risk management by CCPs.

- Provided input to the Treasury on creating a new type of regulated market, a Recognised Auction Platform (RAP) and consulted on changes in April QCP to make bidding for EU emissions allowances a regulated activity.

Supervising the UK Regulated Covered Bond (RCB) Regime

We undertook a review of the UK RCB Regime in 2010/11. Following this review, a joint Treasury-FSA Consultation Paper was published in April 2011 and a Policy Statement (PS11/16) in December 2011. The changes to the regime were seen as a positive step in improving transparency and the overall quality of the regime. The amending RCB Regulations and Sourcebook were published respectively in November and December 2011. We continue to work with issuers to ensure a smooth implementation of, and compliance with, the changes to the RCB Regulations by January 2013. For example, in November 2011 we published guidance on our minimum expectations of the role of the compliance function in RCB programmes. In March 2012 we published further guidance on our minimum expectations of: the signatory of the annual confirmation of compliance; the appropriateness of systems and controls; and the content of Management Information. We also hosted RCB forums to discuss market conditions, regulatory developments and changes to the RCB regime.

Domestic supervisory initiatives – market monitoring

Market integrity

Our market abuse regime applies to anyone whose activity relates to the UK financial markets. It contributes towards our statutory objectives to reduce financial crime (discussed in Section 5) and maintain market confidence. We continue to focus on:

- credible deterrence through targeted enforcement actions (civil and criminal);
- market education through our thematic work;
- developing our markets' surveillance toolkit;
- supervision of the transaction reporting and market abuse regimes; and
- influencing European policy agendas.

Market cleanliness

The *Business Plan* highlights surveillance as a key method to maintain confidence in the UK financial markets. As part of our market monitoring activity, we analyse the scale of share price movements in the two days ahead of regulatory 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 and has remained low in 2011 at 19.8%. These are the two lowest levels since 2003. The fall took place against a backdrop of an increasing focus by the FSA on market abuse and increased

enforcement activity in this area. We cannot determine the causes behind the fall with certainty, but the continued lower measure is welcome nonetheless.

Insider dealing and market abuse

Over the last 12 months we have continued to pursue our credible deterrence strategy forcefully to combat insider dealing and market abuse.

The *Business Plan* flagged a step up in enforcement activity, and we have pursued increasingly large and complex criminal investigations and prosecutions. Following charges in February 2011, Rupinder Sidhu was convicted in December 2011 of insider dealing and sentenced to two years in prison. Four more individuals were charged with insider dealing. We continued to pursue others through the court system. As at March 2012, trials in four major criminal cases were scheduled during 2012 and 15 defendants were being tried or awaiting trial on charges of insider dealing, misleading the market and/or money laundering.

Civil enforcement remains just as important in our overall strategy. During the financial year we issued 13 final notices, with total penalties of £15.6m, and prohibited four individuals as a result of market abuse. Four of these outcomes followed contested Tribunal proceedings.

In November 2011 we imposed our highest ever fine for market abuse of US$9.6m on Rameshkumar Goenka. That case, like others in the last year, has seen us apply our new penalty framework, introduced in 2010.

In the case of Swift Trade we used our new powers to publish the Decision Notice. We also continued with our strategy of seeking High Court injunctions to stop market manipulation in three other cases where the suspected manipulative activity was ongoing. Two of these subsequently settled with the penalties and bans imposed by Court Orders and Final Notices.

Disclosure of inside information

In January 2012 we fined David Einhorn, owner of the US hedge fund Greenlight Capital Inc, and his investment management firm £7.2m for engaging in market abuse regarding an anticipated significant equity fundraising by Punch Taverns Plc. We also fined three other market professionals for their roles in this abuse. The high penalties reflect the seriousness of the breach.

Just outside of our reporting period, on 3 April 2012 we also published our decision to fine Ian Hannam, former Chairman of Capital Markets at JP Morgan Cazenove £450,000 for market abuse by disclosing inside information. This followed a fine of £210,000 on Nicholas Kyprios, Head of European Credit Sales at Credit Suisse, for improper market conduct by disclosing confidential information. These cases reinforce our message that confidential and inside information should be handled with care and that confidential price sensitive information should not be disclosed except in carefully controlled circumstances. Ian Hannam has referred the decision to the Upper Tribunal.

Market education

In 2011/12 we took further steps to enhance market participants awareness of their obligations and to ensure they take all reasonable steps to mitigate the risk of market abuse. Work included:

- Market Watch publications along with a ongoing review of pre-sounding practices which was initiated in 2010.

- Significant work on Suspicious Transaction Reports (STRs), alongside enforcement action against Casper Agnew for failing to submit an STR, fining him £65,000.

- A substantial review of High Frequency Trading (HFT), including visits to firms to test their systems and controls. Our work on HFT supported the production of research through the Foresight[2] Group.

- On Market Fragmentation, we have been working on establishing appropriate mechanisms for exchanging information to allow us to work towards improving the objective of prevention and detection of market abuse in the fragmented trading environment. We have continued our collaborative approach with market infrastructures and other competent authorities and have been building relationships within the Surveillance Practitioners Group (ten major exchanges and trading platforms are represented) to improve the flow of information and enhance engagement of all members.

Markets reporting

Both surveillance of the Market and accurate transaction reporting are essential components of our toolkit for investigating instances of market abuse, including insider dealing.

The *Business Plan* noted the need to review anti-market abuse systems and controls. We have been working closely with firms to ensure they are aware of their obligation to put in place appropriate systems and procedures to ensure the submission of accurate transaction reports.

We also held several Transaction Reporting Forums, giving us the opportunity to highlight issues of concern to the industry and discuss issues and developments related to transaction reporting.

UKLA

In the primary markets, we perform the UK Listing Authority (UKLA) functions, responsible for reviewing and approving prospectuses and circulars, determining eligibility for listing and maintaining the Official List. We enforce the ongoing compliance of issuers and major shareholders with the ad hoc and periodic disclosures required under the Disclosure and Transparency and Listing Rules (DTR). We also authorise sponsors and monitor their performance. These are the specialist firms that help premium issuers draw up listing documents, are responsible for the content, and act as the key link between the UKLA and issuers. We are also involved in the strategic programme to replace the UKLA'S key IT systems, and to deliver associated business change.

This year, we took action against a number of individuals and firms for breaches of the DTRs. We fined Sir Ken Morrison £210,000 for failure to disclose reductions in his shareholdings and voting rights in Wm Morrison Supermarkets plc. We fined and banned Peter Miller and Jamie Corr, two former directors of Cattles plc, for publishing misleading information to their investors. Cattles and its subsidiary, Welcome Financial Services Ltd, were also publically censured for market abuse and breaches of the Listing Rules and Principles. Criminal proceedings are also underway, with three former directors of iSOFT plc on trial for conspiracy to make misleading statements. A fourth defendant is awaiting separate trial on the same charges.

2 The Foresight Group reports to the Department of Business, Innovation and Skills and uses scientific and other evidence combined with analysis to tackle complex issues and help policy making.

Listing Rules enhancement

As set out in the *Business Plan*, we consulted on a number of changes to the substantive content of the Listing Rules. In January 2012 we published a Consultation Paper [CP12/2] setting out proposed amendments to the Listing Rules. The CP proposed amendments to a number of areas of our rules to ensure that the primary market can continue to operate effectively and that new risks are appropriately mitigated. In addition, and in response to the renewed debate around corporate governance, the CP sought views from market participants about whether the premium listing standard provides an appropriate level of investor protection.

First public censure of sponsor in relation to the Listing Rules

In June 2011 we censured BDO LLP (BDO) for failings while acting as a sponsor during Shore Capital Group plc's (Shore Capital) takeover of Puma Brandenburg Limited. This is the first public censure of a sponsor, by the FSA, in relation to the Listing Rules.

The UKLA relies on sponsors to ensure that issuers meet their obligations under the Listing Rules and it is therefore crucial that sponsors deal with us in an open and cooperative manner, and perform sponsor services with due care and skill. Despite these requirements, BDO failed to liaise with the UKLA before the announcement of the transaction to ascertain whether Shore Capital's shares should be suspended. We concluded that BDO's conduct did not satisfy the requirements for a sponsor under the Listing Rules.

Transaction Reporting System (TRS)

We sold our Approved Reporting Mechanism (ARM), known as the Transaction Reporting System (TRS), to the London Stock Exchange (LSE) for £15m in October 2011.

The TRS was an ARM established in the UK market for reporting transactions in regulated instruments by firms in accordance with SUP 17 of the FSA Handbook and Article 25 of MiFID. We use this information to detect and investigate suspected cases of market abuse, insider trading, market manipulation and also use the information as part of monitoring supervised firm activity.

A decision to sell TRS had not been made at the time of the *Business Plan*. However, there is now a competitive market for transaction reporting services for industry. We are confident that the ARM market is now sufficiently developed to enable firms to meet their reporting obligations to us and we concluded that maintaining an ARM no longer formed part of our core role as a regulator.

SABRE/ZEN

We delivered the SABRE/ZEN system in 2011, which underpins our arrangements for monitoring firm and investor activity in regulated instruments, with the aim of detecting potential market abuse. It includes a database of market transactions undertaken by authorised firms.

It represents an enhanced system that can now be developed further to significantly improve our intelligence-based detection of market risk or market abuse.

International policy initiatives

Over-the-counter (OTC) derivatives

Our CEO noted in the *Business Plan* that our principle objective for reforming OTC derivatives is to reduce systemic counterparty risk. We continue to support this, enabling greater transparency of OTC markets and harmonising standards for clearing houses. In 2011/12 we

were involved in, or led the drafting of, a number of international standards that will set an international framework for the reform of global OTC derivatives markets.

Last year, we:

- continued to chair the OTC Derivatives Regulators' Forum;
- participated in the editorial team developing CPSS-IOSCO (Committee on Payment and Settlement Systems – International Organization of Securities Commissions) principles for Financial Market Infrastructures;
- co-chaired an IOSCO taskforce on OTC derivatives and led work on drafting an IOSCO report setting standards for the implementation of a mandatory clearing obligation for derivatives products and OTC derivative trading platforms; and
- monitored progress of reform against G20 objectives as part of the FSB.

Alongside this, the EU reached agreement in February 2012 on the European Market Infrastructure Regulation (EMIR). This implements in the EU the G20 commitments to centrally clear standardised OTC derivatives and have all OTC derivatives reported to trade repositories. EMIR will establish a pan-EU regime for central counterparty clearing houses, risk management of non-centrally cleared trades and trade repositories. With this in mind, in 2011/12 we:

- worked with the Treasury and the Bank to influence the level 1 EMIR legislation; and
- played a leading role within relevant European Securities and Markets Authority (ESMA) taskforces to draft regulatory technical standards required by EMIR (ESMA published a Discussion Paper on proposed technical standards for EMIR in February 2012).

Market in Financial Instruments Directive (MiFID)

Our CEO, Hector Sants, highlighted in the *Business Plan* the importance of MiFID and the need to ensure its impact is appropriate for current and future market developments.

The European Commission published the MiFID/Market in Financial Instruments Regulation (MiFIR) proposal in October 2011. This included a range of measures influenced by the experience of the financial crisis, such as improving investor protection and enhancing the transparency of markets. Leading up to this we worked with the Treasury and ESMA to inform the proposals.

Since the proposal's publication in October 2011, we have provided active support and input into the Treasury's negotiation of the amended legislation in the European Council and Parliament. Our aim is for the proposals to promote investor protection, and transparency while:

- appropriately reflecting differences in market structure across asset classes; and
- promoting competition, including by allowing appropriate access to EU markets for third country firms and investors.

Our work on market structure issues has not been confined to the MiFiD review. We have worked in ESMA to produce guidelines for firms, trading platforms and competent authorities

on systems and controls for trading in a highly automated environment.[3] These were published in December 2011 and competent authorities and financial market participants have to make every effort to comply with them from 1 May 2012. We have held industry roundtables to publicise and talk through the guidelines.

We also contributed to IOSCO's report on regulatory issues raised by the impact of technological changes on market integrity and efficiency published in October 2011.[4] The report contains a number of recommendations aimed at promoting market integrity and efficiency and mitigating the risks posed to the financial system by the latest technological developments, including high frequency and algorithmic trading. The recommendations were developed in response to the G20 leaders' request in November 2010. We have also actively participated in researching the impact of highly automated trading strategies, such as high frequency trading, and we participate in the stakeholder group overseeing the government sponsored Foresight project on the Future of Computer Trading in Financial Markets.[5]

Commodities

We aim to ensure that commodity derivatives markets remain efficient and liquid, and ensure that regulators have appropriate information and powers to supervise them effectively and, as the *Business Plan* highlighted, the need to combat market manipulation and control or limit price movements. With this in mind we:

- Supported the Treasury in the negotiation of relevant new and amended directives and contributed to commodities related aspects of the EMIR, MiFID, MAD and CRD Reviews.

- Co-chaired an IOSCO Commodities Taskforce to implement the resulting legislation in 2013/14. The taskforce produced two papers, one on principles for the regulation and supervision of commodity derivatives markets, and another on oil price reporting agencies.

- Published a research paper[6] on the drivers of the oil market and the price volatility seen over the period as a contribution to the debate following significant regulatory and political interest in oil markets over the past couple of years. We leveraged content and messages from the paper as part of advocacy strategies in relevant political (G20) and legislative reviews (MiFID, MAD).

- Took on chairing a newly formed ESMA Commodities Task Force in November 2011.

Transparency Directive

The Transparency Directive (TD) requires companies trading securities on regulated markets in EU member states to publish financial information across the continent. The European Commission published proposals for changes to the TD in October 2011 and we provided technical input to the Treasury to inform the UK position. We continue to provide active support and input to the Treasury's participation in negotiation of the legislative proposals.

Market Abuse Directive (MAD)

In 2011/12 we were heavily engaged in reviewing MAD 2003. The European Commission

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3 ESMA/2011/456, www.esma.europa.eu/system/files/2011-456_0.pdf
4 FR09/11, www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf
5 www.bis.gov.uk/foresight/our-work/projects/current-projects/computer-trading
6 'The Oil Trading Markets, 2003-2010: Analysis of market behaviour and possible policy responses'.

published proposals to revise the MAD in October 2011, which takes the legal form of a regulation. The Commission also simultaneously published proposals for an accompanying Criminal Sanctions Directive for insider dealing and market manipulation. The Directive is the first instrument to harmonise in EU law criminal sanctions for market abuse. The UK is currently not bound by the Directive, as it is subject to a Justice and Home Affairs 'opt in', but we are engaging heavily in its development. The UK will be automatically bound by the wider EU market abuse framework, provided for in the Regulation.

Short-selling

Level 1 text of the EU Short-Selling Regulation (SSR) was finalised in October 2011. We assisted the Treasury in the negotiations of the Level 1 text and sought to secure enhanced transparency without imposing unreasonable costs and constraints on the efficiency of the markets. Some key elements of the new regulation are:

- reporting of net short positions to regulators and to the market;
- restrictions on naked short selling of equities and sovereign debt;
- ban on uncovered sovereign CDS otherwise than for hedging purposes;
- competent authorities can suspend the ban if the market is not functioning properly; and
- powers for competent authorities and ESMA in emergency situations.

Following the agreement on the level 1 text, an ESMA task force on the short-selling regulation co-chaired by us commenced work on Level 2 binding technical standards (BTS) and advice on Delegated Acts. The BTS were delivered to the Commission in March 2012 with the advice following in April.

Prospectus Directive – Implementing the Amending Directive

The Amending Directive amends the Prospectus Directive and it was published in the Official Journal of the European Union on 11 December 2010. We have joint responsibility with the Treasury for implementing the Amending Directive in the UK by 1 July 2012. We contributed to ESMA's work in providing technical advice to the European Commission on possible delegated acts concerning the Amending Directive. ESMA published two Consultation Papers[7] and two sets of technical advice to the Commission.[8] We published a joint FSA/ Treasury Consultation Paper [CP11/28] on the UK implementation of Amending Directive 2010/73/EU, simplifying the EU Prospectus and Transparency Directives, in December 2011. The consultation closed on 13 March.

Central Securities Depositories

The European Commission published a legislative proposal on improving securities settlement in the European Union and on central securities depositories (CSDs) in March 2011. The Regulation introduces an obligation for dematerialisation for most securities, harmonised settlement periods for most transactions in such securities, settlement discipline measures and common rules for CSDs. In 2011/12 we participated in a Commission expert working group, liaising closely with the Treasury and the Bank of England to inform the Commission in its

7 ESMA/2011/141 and ESMA/2011/444
8 ESMA/2011/323 and ESMA/2012/137

thinking for the legislative proposal. To assist us in this work we engaged with a broad base of market participants and stakeholders.

Credit Rating Agencies (CRAs)

As detailed in the *Business Plan*, CRAs have come under increased regulatory scrutiny because of their role in rating structured financial products in the run up to the financial crisis, highlighting the need for appropriate and consistent regulation of these agencies and activities.

We have been active in continuing to implement and embed the existing European CRA regulatory regime and participating in policy negotiation to revise that regime. CRA regulation is of significant political interest and we have provided evidence to inquiries by both the House of Lords European Union Committee and the Treasury Select Committee, working closely with colleagues from the Treasury and the Bank of England. We also continued to contribute to international forums that are considering both CRA regulation and the use to which ratings are put, most notably the IOSCO Standing Committee 6 and the Financial Stability Board.

Regarding the current regime, we were an active participant in several European supervisory colleges as part of the registration process and we successfully registered five major UK-based CRAs by the end of October 2011 following a robust challenge process. Following revision of the CRA regulatory regime, ESMA assumed responsibility for the future registration and supervision of CRAs from Q3 2011. All Binding Technical Standards (BTS) required under the current regime were successfully agreed by December 2011.

We provided input to ESMA to complete its equivalence assessment of third country regimes to allow ratings issued by CRAs with no presence in the EU to issue ratings used for regulatory purposes, or endorse a rating issued in a third country by an EU registered CRA.

The European Commission published its latest proposals for regulating Credit Ratings Agencies (CRA3) on 15 November 2011 and European negotiations began in Q1 2012. The European Commission's high-level objectives in CRA3 are to reduce mechanistic reliance on credit ratings, improve the frequency and transparency of sovereign debt ratings, eliminate conflicts of interest and enhance competition. The Treasury has led negotiations for the UK, drawing on support from us where required.

Section

4

Delivering consumer protection

Introduction

In March 2010 we announced the introduction of a new consumer protection strategy and the *Business Plan 2011/12* detailed how we would deliver on this new strategy.

Our consumer protection strategy recognises that more should be done to prevent consumer detriment by regulatory actions to make the retail market work better for consumers – with better flows of information to consumers, earlier, more robust supervisory interventions, backed up with stronger enforcement and a focus on securing redress for consumers.

The *Business Plan* noted the need to use business model and strategy analysis to identify firms' potential conduct risks, which may then be tested further through intensive supervision. It also explained our plans to pay more attention to products and product design controls at firms as a way to prevent detriment. It highlighted the need to take regulatory action before consumers are adversely affected on a wide scale, and tough action to seek prompt redress and compensation when consumers suffer detriment. It also acknowledged the increasing importance of the EU's influence over conduct regulation.

This chapter sets out how we delivered on the *Business Plan* aims, set out as:

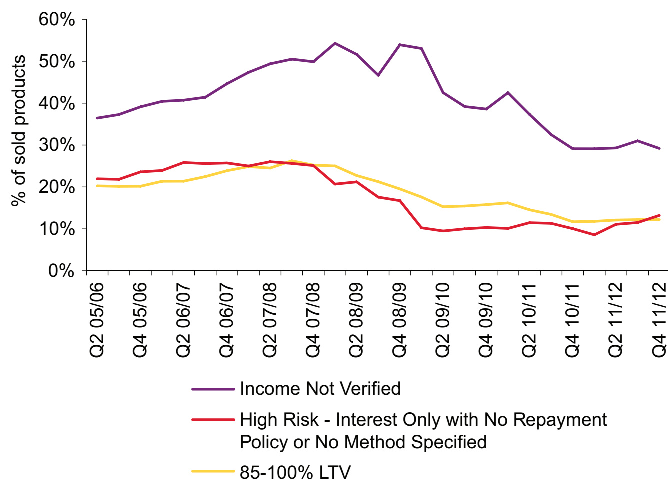
- supervisory initiatives, including strengthening supervisory oversight and a new supervisory and enforcement approach in small firms;
- domestic policy initiatives, including the Retail Distribution Review (RDR), Mortgage Market Review (MMR), unauthorised business, life insurance and packaged bank accounts, and how we deal with situations when conduct does not meet our expectations, including complaints handling, redress and mis-selling; and
- international policy initiatives, including directives on deposit guarantee schemes, packaged products, collective investment schemes and alternative investments.

We have also made organisational changes in support of our consumer protection objective by establishing a Consumer Affairs team to ensure, as an organisation, that we are engaging with consumers so that we can regulate in way that is truly relevant to their needs.

Key metrics

We use a wide range of metrics to assess and measure our work. These include:

Chart 1: Higher risk mortgage indicators

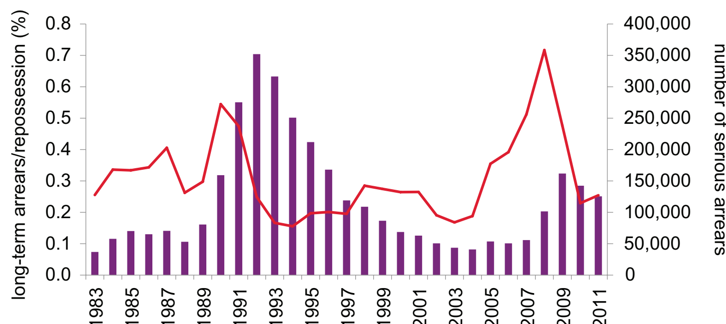


The number of higher risk mortgages in the market is an indicator of retail bank risk appetite. A more significant risk appetite by banks could be to the detriment of consumers if they are mis-sold products.

The proportion of highest risk mortgages, 90%+ Loan-to-value (LTV), has risen in Q4 11/12 to 1.8% following a decline to 1.4% in Q3. The second highest risk mortgage category in LTV (85% to 90%) followed suit, rising 1.3% points to 11.4% in the quarter. Lower risk mortgages declined in percentage terms during Q4 11/12. LTVs of up to 75% decreased within a tenth of a percent while those of 75% to 85% decreased negligibly – from 19.9% to 19.8%.

High risk repayment methods involving interest only mortgages with no repayment vehicles in place stayed unchanged in Q4 11/12 at 12.2%. Interest only mortgages with repayment vehicles (medium risk) in place have further decreased from 3.1% of all mortgages in Q3 11/12 to 2.8% in Q4.

Chart 2: Number of properties taken into possession

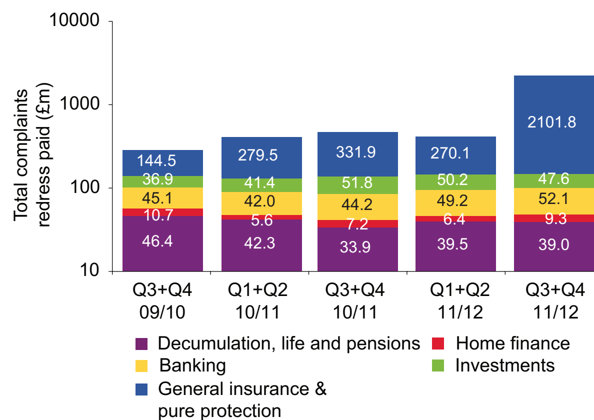


Lenders repossessed about 25% of serious residential arrears cases at the end of 2011, a figure comparable with the forbearance seen after the housing crash in the 1990s, but well below the peak seen prior to FSA intervention and the fall in interest rates in early 2009. At this time, while arrears levels were lower, the numbers of arrears cases reaching repossession was far higher than the early 1990's.

Chart 3: Number of mortgages in arrears

Residential mortgage arrears remain high, but are still below levels seen in the early 1990s. The proportion of loans in long-term arrears has fallen from the recent peak in 2009 Q2 and at the end of 2011, 1.1% of residential loans were in 6 months+ arrears.

Chart 4: Redress paid by firms[9]

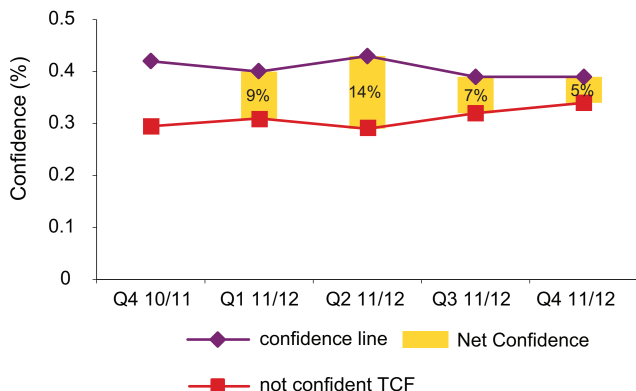


The amount of consumer redress is 397% up on a year ago (Q4 10/11), with the significant increase due to firms processing complaints that had been on hold during the BBA judicial review into PPI.

This may also explain the increase in redress across firm types, particularly banks and building societies (632% increase on Q2 2011) and general insurance intermediaries (318% increase on Q2 2011), as PPI was a product sold in tandem with a range of financial products including insurance and loans.

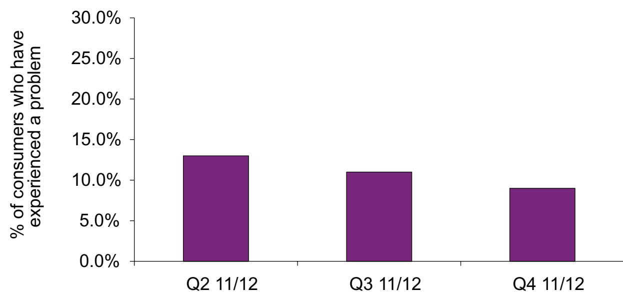
9 Logarithmic scale

Chart 5: FSA Consumer Awareness Survey



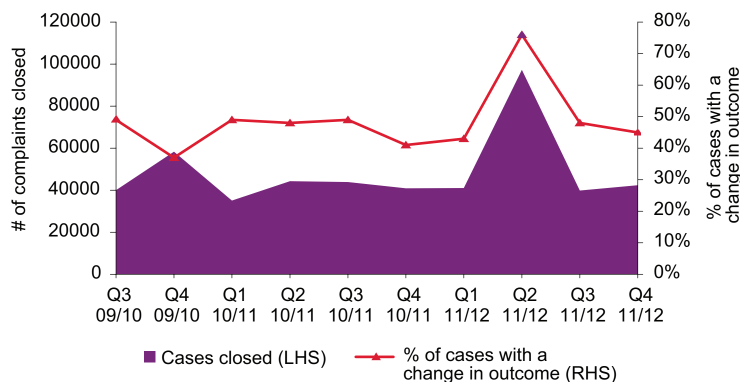
Belief that firms treat their customers fairly has fallen over the past 12 months, while there has been an increase in those unconfident that they are treated fairly by financial firms. This is likely to be the publicity of PPI mis-selling and a general economic pressures.

Chart 6: FSA Consumer Awareness Survey



Overall, the number of reported problems experienced in the last 12 months with financial institutions has diminished in the past year. This has been driven by a fall in those who have been refused service or those being given advice they did not have confidence in. Reported problems of long queues, rude and unhelpful staff and difficulties over the phone have remained steady, while there have been slight increases in problems referring to PPI and complaint handling.According to the GfK Consumer Confidence Index, confidence has fallen 2 points to -31, three points lower than March last year.

Chart 7: Complaints made to Financial Ombudsman Service



The number of complaints closed by FOS in Q4 11/12 increased by 6% from 39,843 in Q3 11/12 to 42,401. PPI complaints still account for the largest proportion of all closed complaints. Banks (other than Wholesale only) accounted for the largest share of closed complaints in Q4 11/12.

The FOS received 76,740 complaints in Q4 11/12, an increase of 40% from the 54,718 received in Q3 11/12. The proportion of complaints closed with a small or substantial change in outcome (where the FOS has disagreed with the firm's decision on the complaint) has decreased from 48% in Q3 11/12 to 45% in Q4 11/12.

The data only relates to complaints about FSA Authorised firms.

Retail Conduct Risk Outlook

In March 2011 we published the Retail Conduct Risk Outlook (RCRO), where we set out our assessment of the most significant retail conduct risks in the markets we regulate in the next 12-18 months. We have asked firms to review the RCRO and consider the risks that are relevant to the sector(s) they operate in, and to assess whether they have taken sufficient action to meet the challenges represented. The RCRO is based on our ongoing internal risk intelligence and gathering.

Supervision

Strengthening supervisory oversight

In the past our regulatory approach has been based on the assumption that effective consumer protection would be achieved provided sales processes were fair and product feature disclosure was transparent. However, this approach has not always been effective in preventing severe customer detriment. We recognise that there are fundamental reasons why financial services markets do not always work well for consumers.

The *Business Plan* highlighted our new regulatory approach, initiated in 2010, which includes earlier intervention as a means of stopping problems before they gain traction, and engaging with firms to ensure that new products really do serve the needs of the customers to whom they are marketed. We published a Discussion Paper (DP11/1) on this subject in January 2011, following which we issued a Feedback Statement (FS11/3) in June 2011. This new approach is a guiding principle for a number of initiatives taken over the course of this year, such as:

- our review of retail structured product development and governance;
- a consultation exercise on guidance stating that traded life policy investments are not suitable for retail customers (this is to be followed by a consultation on rule changes for unregulated collective investment schemes generally to restrict retail access further); and
- including product intervention powers in the Financial Services Bill and MiFID II that will enable the regulator in the future to take strong and effective action on products, where necessary.

Business model and strategy analysis

Business model and strategy analysis (BMSA) is our detailed assessment of the conduct risks posed by an individual firm's business model. Using the wider market or sectoral context set by the RCRO, the BMSA assesses if, or how, the identified risks manifest themselves in a particular firm, as well as seeking to highlight any risks specific to that firm.

This is a very detailed analysis of a firm's business model and strategy, considering the markets in which it operates and viewing it in the context of its peer firms. We assess whether and how a firm's business model and future strategy give rise to conduct risks, including the impact of competitor activity. We then assess how customers may suffer detriment as a result and use this data to judge the coherence, feasibility and reasonableness of the firm's strategy, considering the impact that relevant factors (e.g. competitor activity) will have on that strategy. We then assess how customers may suffer detriment as a result.

We have started to roll out the BMSA for all the large, complex banking groups. To date, one has been completed and a further three are underway, with all of the largest banking groups scheduled to have been through the exercise at least once before the end of this financial year. This work will inform our supervisory approach, during the period before legal cutover, and will be the foundation of our supervisory approach thereafter.

The supervisory approach in small firms

The *Business Plan 2011/12* noted that in 2011 we would complete our three-year assessment programme for small firms, after which we would adopt a new, proactive supervisory approach, but which would nevertheless include many of the strands in the current assessment programme, including roadshows, assessments and follow-up visits.

The new Small Firms Regulatory Review Programme was launched in June 2011 and the first regional assessments and reviews undertaken in January 2012. We launched our four-year rolling regional assessment programme, which consists of road shows undertaken in the regions, followed by assessments (face-to-face, by telephone, or via an online assessment form). Random verification visits are then undertaken to verify the information provided by firms during the assessment or, if applicable, follow up supervisory action where firms were unable to demonstrate that they had effective governance, culture and/or controls.

It is estimated that all low impact retail firms will receive an assessment over the next four years. So far, over 1,100 firms have attended road shows, over 300 firms have received face-to-face assessments, and we will shortly begin our follow up work from Region 1.

We continue to deliver credible deterrence in the small firm intermediary market. We published 44 final notices and of these 24 were findings against Significant Influence Function (SIF) holders.

We have obtained an increasing number of outcomes in relation to Unregulated Collective Investment Schemes (UCIS). This reflects our ongoing concerns in relation to the sale and promotion of UCIS. We continue to take action against intermediaries involved in mortgage fraud as a result of information received from the Information from Lenders scheme.

Enforcement action

- We imposed nine full or partial prohibitions and nine fines totalling £262,600 for failings in relation to UCIS.
- We imposed 11 full or partial prohibitions and eight fines totalling £885,699 on mortgage fraud.
- We imposed three prohibitions and one fine totalling £195,117 regarding insurance fraud.
- We imposed one prohibition and two fines totalling £18,050 for client money failings.
- We published public censures in relation to two credit unions.

Mis-selling and poor treatment of customers

In the *Business Plan* we promised to support our supervisory approach by taking robust enforcement action where we have found poor treatment of customers, including securing significant amounts of redress when customers have been mis-sold. In particular, we have taken action in the following areas: structured products, UCIS, Payment Protection Insurance (PPI), mortgage advice and the treatment of mortgage customers with mortgage arrears, and the protection of client money.

- In December 2011 we imposed our largest ever retail fine of £10.5m on HSBC for mis-selling investment products to elderly customers. Between 2005 and 2010 NHFA Limited, a HSBC subsidiary, advised 2,485 customers to invest in asset-backed investment products to fund long-term care costs for elderly customers. However, these investments are typically recommended for a minimum period of five years, and in a number of cases these investments were sold to individuals with a life expectancy below the recommended investment period. HSBC is conducting a past business review and redress is likely to amount to £29.3m.

- In November 2011 we fined Coutts and Company (Coutts) £6.3m for failings related to sales of the AIG Enhanced Variable Rate Fund to 427 of its customers, with investments totaling £1.45bn. There were a number of serious failings in the way the fund was sold. We found that as a result of the failings, Coutts' customers were exposed to an unacceptable risk of an unsuitable sale of the fund. Coutts is compensating all customers who have suffered a loss.

- In September 2011 we fined mortgage lender Swift 1st Limited (Swift) £630,000 for a number of serious failings in relation to its arrears fees and charges, and in relation to its dealings with customers in arrears. During the relevant period, Swift administered an average of approximately 3,000 regulated mortgage contracts per month, with an average total value of £211m. Since 31 October 2004, approximately 4,300 of Swift's customers paid excessive fees and charges. The firm has agreed to provide redress to those customers who were affected and it is estimated that redress as a result of these failings will be approximately £2.35m.

- In December 2011 we fined Combined Insurance Company of America (CICA) £2.8m for failing to ensure its customers were treated fairly. We found that there were systemic failings at the firm and as a result there was a failure to embed a culture that ensured its customers were treated fairly. This created a significant risk that customers would not get a fair deal. CICA sold 238,993 policies during the relevant period and agreed to carry out a past business review. Redress will be paid to customers who have suffered detriment.

- In March 2012 we varied by agreement the permissions of Card Protection Plan Limited to impose important requirements on the firm to protect consumers and ensure redress in cases of mis-selling. In particular, we required the firm to change its process for periodically renewing customers who had bought its Card Protection and Identity Protection products. We also imposed on the firm a past business review of its direct sales of the products to ascertain the customers that may have suffered detriment and the extent of any loss.

- **CF Arch cru funds:** On 13 March 2010 dealings in the CF Arch cru funds, two FSA-authorised funds, were suspended on the grounds of insufficient liquidity to meet anticipated redemption requests. On 21 June 2011 a £54m redress package was agreed with Capita Financial Managers Ltd, Bank of New York Mellon Trust and Depositary (UK) Ltd and HSBC Bank plc. Most recent estimates are that this could allow investors to recover an average of 66% of the published net asset value of their investments as at the date of the suspension of dealings in the funds. We believe that this package helps provide some certainty for investors and will accelerate the return of value to investors. This is a complicated matter, involving cross-jurisdictional issues and multiple participants and we are considering the role of other parties in relation to the CF Arch cru funds. We have been liaising with the Financial Ombudsman Service and the Financial Services Compensation Scheme in this matter.

Update on Keydata

The investigation into Keydata and its former CEO, Mr. Ford, is ongoing and is at an advanced stage. Our disciplinary proceedings 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 Court held that Mr. Ford could claim joint legal privilege with Keydata for two particular documents. As a result, a remedies hearing was held in February 2012 to determine what relief it was appropriate to give Mr Ford. On 18 April 2012, the Court rejected Mr Ford's proposal that the warning notice issued to him should be quashed and decided that our investigation team could remain in place and our disciplinary proceedings could continue based on a warning notice that has been redacted to remove the privileged material. The Court also held that we must take steps to identify, destroy, delete or redact the privileged documents and certain other documents that refer to the contents or substance of them. The judgment notes that we did not act in a 'high-handed way' and that we took legal advice at all times which was vindicated to a very substantial degree. Our work in this area remains a priority for us given our statutory objectives and the public interest in the Keydata matter.

Unauthorised business

In 2011/12 our main focus has been on three risks to consumers posed by unauthorised businesses: share fraud (often known as boiler rooms); landbanking; and get-rich-quick investment scams. We focus on these because they are, in our experience, types of unauthorised business that cause most harm or risk of harm to the public.

Our investigations resulted in action being taken against unauthorised schemes which had caused over £160m of losses to their victims made up of £28m in share fraud, £62m in landbanking schemes, and £70m in get-rich-quick schemes. Ten injunctions were obtained to shut down schemes and freeze assets. Restitution Orders were made for £32m to be returned to consumers. £27m was actually secured for distribution back to consumers.

As a result of our investigations, four share fraudsters were sentenced to terms of imprisonment, with sentences ranging from 2.5 to 9 years. The *Business Plan 2011/12* highlighted the need for increased warnings to consumers, to help them recognise such schemes and avoid investing in them. This year, for the first time, in addition to traditional media we produced various videos, available on our website and YouTube, to help people to recognise and avoid investment scams.

Landbanking

We have been actively engaged in tackling landbanking by firms that are not authorised to conduct investment business. These firms cold-call customers to sell 'hope value land', which is land that does not have planning permission, but where the hope is that one day it will achieve such permission. It is sold to the investor at a price higher than agricultural or non-building land, but with an expectation that it will make significant profits when planning permission is granted. Landbanking is often run on a criminal, fraudulent basis – where the land has no hope of achieving planning permission. It is also often run as a collective investment scheme, whereby a group of investors are encouraged to take a share in a larger parcel of land.

In 2011 we brought together a group of law enforcement agencies, each with different interests in tackling landbanking. These agencies included the City of London Police, the Insolvency Service, the Crown Prosecution Service, the Solicitors Regulatory Authority and the Land Registry. Between them, these agencies aim to ensure that cases are investigated by the agency best-placed to tackle the particular threats posed to consumers by each particular landbanking firm.

Action taken by us during 2011 resulted in eight injunctions being obtained against landbanking firms that had caused £62m of losses to consumers. £9.4m was secured for intended future distribution back to victims of these schemes. Beyond this, many further landbanks were disrupted without the FSA resorting to legal proceedings; and cross-referrals were made to the Police and The Insolvency Service to take action. Alongside this, we have conducted a wide-ranging consumer guidance campaign through the media, designed to warn the public about the dangers posed by investing through unauthorised landbanking firms.

In March 2012 we took action against James Maynard, Countrywide Land Holdings Limited and Plateau Development & Land Limited. Maynard sold plots of land across the UK with the promise that investors would make a significant profit when the land obtained planning permission. Investors, who handed over £35m, were told by sales staff that Maynard, Countrywide and Plateau would apply for planning permission for the land or that they had corporate buyers lined up to purchase the sites. In reality there was no intention to seek planning permission or help purchasers sell their land. The plots were in locations unlikely to ever gain planning permission. We secured a judgement against Maynard who was also made bankrupt and banned for life from selling plots of land for business purposes. Orders were also made for Maynard, Countrywide and Plateau to hand back money taken from their victims.

Authorisations

The *Business Plan* highlighted that we remain committed to improving standards of governance across the financial services industry. In 2011/12 the Authorisations Division has been supporting the re-structuring of the industry after the financial crisis. We have approved over 400 individuals

to hold key positions within financial services firms in 2011/12 through our enhanced SIF regime. We have also supported the banking sector through the challenges of re-adjusting post crisis, for instance by supporting the change in control process for Northern Rock. We have also authorised 1172 firms, including some large and novel institutions, such as Big Society Capital. Please refer to appendix 7 for more analysis on Authorisations' performance in 2011/12.

Key domestic policy initiatives

The MMR

In December 2011 we took another major step in the MMR and published a Consultation Paper setting out a comprehensive package of proposals for reform in responsible lending, distribution, disclosure, arrears charges and management, prudential requirements for non deposit taking lenders and adaptations of the rules for niche mortgage markets.

The process of developing these proposals has been a long one. It began with a Discussion Paper published in 2009, and followed by several Consultation Papers published along the way. We indicated from the outset the importance of taking time to fully understand what went wrong, and explore all available options for putting things right. We have informed our policy development through an evidence-led approach, based on detailed analysis of the past and present mortgage market, drawing on our dataset of over 4.3 million mortgages. We have also undertaken extensive discussion and debate with market participants, and considered policy developments at both an EU and international level, seeking to draw upon the experience of other markets, as well as sharing the findings of our analysis.

In the course of this process, we have amended our initial proposals significantly, in light of feedback and further analysis and reflection. While this has taken time, it reflects our commitment to getting the regulation of the mortgage market right, which we believe is vitally important.

At the core the latest set of proposals are three principles of good mortgage underwriting that we believe to be crucial to prevent the return of the tail of poor-lending that was witnessed in the lead up to the financial crisis:

- Mortgages and loans should only be advanced where there is a reasonable expectation that the customer can repay without relying on future house price rises. Lenders should assess affordability.

- This affordability assessment should allow for the possibility that interest rates might rise in future. Borrowers should not enter into contracts that are only affordable on the assumption that low initial interest rates will last forever.

- Interest-only mortgages should only be granted where there is a believable strategy for repaying the capital that does not rely on the assumption that house prices will rise.

We believe these are common sense principles and are therefore consulting on making these principles FSA rules.

Another key proposal is that advice will have to be given in the vast majority of sales where there is interactive dialogue with the consumer. This is to help ensure that consumers get mortgage products that are matched to their needs and circumstances.

As part of the consultation, we published a detailed indicative cost benefit analysis of the measures, which set out our best estimate of the impacts on the mortgage and wider housing market, as well as on particular borrower types, such as first-time buyers.

The formal consultation period closed on 30 March 2011 and we are now in the process of considering the feedback, continuing detailed dialogue with stakeholders.

The RDR – implementation

The RDR is another key element of our consumer protection strategy, which the *Business Plan* set out, designed to establish a resilient, effective and attractive retail investment market that consumers can trust in. Most of the final rules come into force at the end of December 2012, and are the culmination of six years' work, involving very extensive consultation and research. We encouraged ideas and views from industry practitioners, consumer representatives, investors and potential investors, trade associations, professional bodies and other stakeholders on the issues that needed to be addressed. We also asked them to identify potential solutions that we could research before finalising our policy and rules. We are now working with firms to help them prepare for the implementation of the new rules, including running a large number of workshops and surgeries to help smaller firms, and publishing factsheets and newsletters.

The new rules require advisers to be paid only through adviser charges (and not commission), disclose whether they provide independent or restricted advice, and meet new professional standards through obtaining higher levels of qualifications and Continuing Professional Development (CPD). During the past year:

- We finalised rules requiring firms to notify us about complaints received relating to individual retail investment advisers.
- We published, in the FSA Handbook, the list of RDR qualifications, meeting modernised qualification requirements that advisers can choose to take. The modernised qualifications are at a higher level than the previous requirements and cover more detail in areas such as investment risk and ethics. There is a range of qualification types available, from traditional written examinations to competency assessments, designed to offer advisers choice in how they demonstrate their knowledge is at the required standards. We will continue to build this list.
- We published a list of accredited bodies that can issue a Statement of Professional Standing as independent validation that advisers are meeting the required professional standards. These bodies will play an important role to raise and help monitor standards.
- We published rules for platforms, to ensure that we regulate them in a way that achieves the objectives of the RDR. We will also consult on proposals to ban payments by providers to platforms and cash rebates by providers to consumers, which have the potential to hinder the transparency and clarity of relationships and charges for consumers.

The different elements of the new regime are all in place, and we expect firms to be actively working towards being ready for the deadline of 31 December 2012.

Packaged bank accounts

Packaged bank accounts provide a set of financial and non-financial products in a bundle. Our review concluded that some consumers can get value from the way these accounts are currently packaged, depending on the features they use. However, the bundling of many different products together can make it difficult for consumers to focus on the important information when it comes to making informed decisions.

Our key concern in this area has been to protect consumers from suffering any detriment if they buy insurance policies as part of a packaged bank account but only later find that they are not eligible to claim. Therefore, we proposed new eligibility and suitability rules for the sale of general insurance contracts as part of a packaged bank account. We published a Consultation Paper in October 2011 (CP11/20) proposing these new rules. The consultation closed on 27 January 2012, following which we have reviewed the responses received.

We consulted widely with industry and consumer stakeholders and considered various options to improve outcomes for consumers. These were:

- preventing firms from bundling insurance policies with a bank account;
- new disclosure requirements to ensure the customer has the information that they need; and
- new rules explaining the steps firms must take on eligibility and suitability for these sales.

We identified that some consumers like buying their insurance bundled in this way and can get value from the package, so we did not think that preventing their sale would deliver the right consumer outcome.

In addition, ongoing discussions with industry delivered actual benefits for the customer, with some firms making changes to their procedures, during the course of the review, such as:

- removing the need to register certain insurance policies to be eligible to claim;
- changing the way that pre-existing medical conditions under the travel insurance are screened; and
- reminding customers to check regularly whether the insurance policies in their package meet their needs.

Consumer engagement

To ensure we are more outward facing and engage better with consumers, we have created a Consumer Affairs team. This will ensure we approach regulation in a way that is relevant to the needs and behaviours of consumers.

The team has a developing remit to embed the consumer perspective throughout the policies and activities of the FSA. The team offers support and challenge, as well as tools and information that allows us to take a more pro-active approach to regulation.

Complaints handling

A firm's approach to complaints handling is an important indicator of whether it treats its customers fairly. It is crucial to building confidence in financial services that consumers are confident they will be dealt with properly if things go wrong. A proper assessment and root cause analysis of complaints can help firms identify problems earlier and take action to prevent them growing. Our review into the quality of complaint handling in major banking groups, published in April 2010, found poor standards in most of the banks assessed. Following this review we consulted on rules aimed at strengthening all firms' complaint handling. In the *Business Plan* we promised to set out our final proposals on complaints handling and in May 2011 we made the following changes:

- we abolished the two-stage complaints-handling process;
- we required firms to identify a senior individual responsible for complaints handling; and
- we set out guidance on how firms can meet existing requirements for root cause analysis and taking account of FOS decisions and other guidance.

As a result of this review, in May 2011 the Bank of Scotland was fined £3.5m for its complaints-handing failures, and they are currently undertaking a compensation exercise estimated at £17m of redress for consumers. We also increased the FOS award limit to £150,000, with an effective date of 1 January 2012.

We have continued our intensive supervisory approach in this area and followed up on our previous review work to test whether improvements have been made by firms and to establish if firms are providing fair outcomes. We have also continued to publish data about firms that report 500 or more complaints every six months. We believe that using transparency as a regulatory tool provides firms with incentives to improve their complaints performance.

Redress

In October 2011 we announced the formal restart of the Financial Services Compensation Scheme (FSCS) Funding Model Review, which is considering the funding arrangements of the FSCS, including considering the effect of any directive-led requirements. We remain committed to ensuring that the funding arrangements are fair, proportionate and sustainable. Also, in October 2011, we started an indepth review to assess whether deposit takers have the systems in place to provide data to the FSCS so that it can pay the majority of depositors within seven days of their bank, building society or credit union failing.

In December 2011, we started a consultation proposing that deposit takers prominently display, in their branches and on their websites, posters and/or stickers detailing deposit protection arrangements.

During the year, we also reviewed aspects of the FSCS to ensure that, if a firm fails, consumers receive timely and appropriate compensation. In March 2012, we proposed some technical changes aimed at improving the speed at which the FSCS can pay compensation and also sought feedback on the adequacy of our existing arrangements for dealing with the failure of a life insurer.

Life insurance

In light of our findings on the with-profits regime review, we pledged in the *Business Plan* to follow up on proposals to strengthen the effectiveness of our with-profits regime. In February 2011 we began a consultation on rule changes resulting from the work on the with-profits regime review.

We have undertaken further discussions with the industry and stakeholders since the consultation period ended, with a view to publishing rules that address the issues raised by the review and improve outcomes for with-profits policyholders.

A Policy Statement confirming rule changes on protecting with-profits policyholders was published in March 2012. We will monitor how firms react to the revised rules, particularly to changes in governance intended to strengthen oversight of conflicts of interest affecting policyholders and improving the quality of advice provided to governing bodies.

More widely in the area of life insurance, Solvency II introduces a number of prudential changes to unit linked and index linked insurance business, as well as to with-profits funds, many of which have an impact on conduct of business regulation.

Reward in firms

This year we have carried out thematic work looking at financial incentives arrangements for in-house sales forces across a sample of firms and sectors. We recognise that firms may need to incentivise staff, however, reward can drive inappropriate behaviour that can lead to consumer detriment. We expect firms to treat their customers fairly, which includes managing the risks associated with reward. We assessed whether the financial incentives within our sample firms increased the risk of inappropriate selling and whether the risks were adequately mitigated. At an individual firm level we found a number of incentives schemes that significantly increased the level of risk, which was not being adequately mitigated. We have continued to take action against firms where appropriate, including follow up on firms' remedial actions.

Review of suitability of wealth management firms' clients' portfolios

We define wealth management as where a client has signed an overarching agreement with a firm to have their assets and/or investments managed on a discretionary or advisory basis.

The *Business Plan* noted that we have carried out a review of the suitability of wealth management firms' clients' portfolios. As a result of this we wrote to 16 firms involved in the wealth management industry to outline areas of concern. Our review highlighted several key areas of concern – for example, we saw an inability to demonstrate suitability because of:

- lack of basic know-your-customer (KYC) information and/or out-of-date KYC information;
- inadequate risk-profiling;
- lack of records of clients' financial situations (assets, source and extent of income, financial commitments); and
- failure to obtain sufficient/any information on client knowledge, experience and objectives.

We found a high risk of unsuitability due – in summary – to:

- inconsistencies between portfolios and the client's attitude to risk; and
- inconsistencies between portfolios and the client's investment objective, investment horizon and/or agreed mandate.

Due to the generally poor results of our initial set of file reviews, we sent a 'Dear CEO' letter to wealth management firms in June 2011. In the letter we explained the issues we had identified and suggested that they might want to:

- assess whether files had relevant, meaningful, accurate and up-to-date client information;
- look into the depth, breadth and quality of client information; and
- consider whether the client portfolios, and the current holdings in client portfolios, were suitable, based on the documented client information they held.

We analysed the responses and used the results to shape follow-up work with a number of firms. We also agreed remediation plans with most of the firms involved to address identified failings. In three cases, firms were required to appoint a skilled person under s166 FSMA, to produce proposals for the remediation of customer files and assess whether actual detriment had occurred due to customers being placed in portfolios inappropriate to their risk appetite and investment objectives.

We monitored the progress of both the s166 reports and the other remediation exercises against the timetable agreed with the firms. We also ran a series of industry seminars for compliance staff and compliance consultants in wealth management regarding our requirements on suitability and record-keeping.

Credit Suisse

In October 2011 we fined Credit Suisse (UK) Limited £5.95m for systems and controls failings in relation to sales by its private bank of structured capital at risk products (SCARPs). SCARPs are complex financial products that provide income to customers but also expose them to the risk that they lose all or part of their initial capital. We found there were systems and controls failures in relation to assessing customers' attitudes to risk, proving the suitability of these products for customers and monitoring the advice given by staff. These failings exposed customers to an unacceptable risk of being sold a product that was unsuitable for their needs. The firm agreed to carry out a past business review, overseen by an independent third party. Redress will be paid to customers who were advised to purchase an unsuitable SCARP.

Banking, including compliance with Banking Conduct Regime

As part of our ongoing consumer protection strategy, the *Business Plan* set out our plans to continue to closely monitor firms' compliance with the Banking Conduct Regime, with a particular focus in 2011/12 on payment ordering and speed of transfers.

On Payment Ordering, we looked into the risk of banks' prioritising debits over credits to maximise fees in relation to their management of customers' accounts. We have reviewed a sample of firms' processes in relation to ordering transactions into, and out of, payments accounts.

We did not find evidence to suggest that firms prioritise debits over credits; however, we did observe that different firms have different approaches to how they manage payments in and out of their customers' accounts.

On speed of transfers, from 1 January 2012, all firms have been obliged to introduce 'Faster Banking' (i.e. complete all telephone and online banking transactions by the end of the next working day).

We engaged with both trade bodies and directly with firms to raise awareness of their obligations under the Payment Services Directive and to check the readiness of our firms to implement this.

Over 99% of sort codes met the 1 January deadline and we are working with those firms that are still not fully compliant. We will take supervisory action where we find evidence of consumer detriment.

Consumer credit

In December 2010 the government consulted on reforming the regulation of unsecured consumer credit, with a preferred option of transferring responsibility from the Office of Fair Trading (OFT) to the FCA. In January 2012, it announced that the Financial Services Bill would include provisions enabling a transfer to the FCA, under the same legislative framework as other financial services, while retaining existing core consumer rights and protections in the Consumer Credit Act. The government would exercise these powers, after consultation, if and when it has identified a model of FCA regulation that is proportionate for the different segments of the consumer credit market (http://www.hm-treasury.gov.uk/consult_consumer_credit.html).

We are working with the government, the OFT, consumer and industry stakeholders on designing a model of FCA regulation that takes account of the risks of consumer detriment across the wide range of regulated activities (which include debt advice, management and collection as well as lending) but also remains proportionate in terms of costs to business. We expect to consult early in 2013 on the high-level design for such a regime.

Key international policy initiatives

Deposit Guarantee Schemes Directive

The Deposit Guarantee Schemes Directive (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 in the UK we have a target seven day payout for the majority of 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.

We have been supporting the Treasury in its political negotiations with the European Council to arrive at an agreed Council position, and a general approach was agreed in June 2011 on preferred revisions to the DGSD. However, changes to the DGSD still need to be finalised and are subject to further negotiations in Europe.

PRIPs

The European Commission has proposed to address inconsistencies in investor protection for various types of investment products, termed Packaged Retail Investment Products (PRIPs).

The intention is to put in place consistent and effective standards, governing both the sale of products and the information that investors receive, across a wide range of investments.

In the UK, we have already chosen to apply various standards from the Markets in Financial Instruments Directive (MiFID) to insurance-based investments, meaning that we have achieved consistent standards in many areas – but the new legislation will also harmonise standards for structured deposits.

While a revised version of MiFID was published in October 2011, other draft European legislation on PRIPs – a new regulation and changes to the Insurance Mediation Directive (IMD) – were expected in 2011 but not published.

In preparation for the legislation, we have been working with the Treasury and other European regulators to try to influence the Commission in the coming months, to try to ensure that the new legislation delivers effective and appropriate investor protection. We have highlighted the risk of the new standards diverging unnecessarily for different products, owing to the Commission's plan to deliver the PRIPs initiative through three separate pieces of legislation (MiFID II, IMD II and a new PRIPs Regulation).

UCITS IV/V

The UCITS Directive sets EU-wide standards for collective investment schemes (pooled investments) that can be sold to retail investors.

A major overhaul of the legislation, known as 'UCITS IV', had to be in place by 1 July 2011, involving new Directives and Regulations. Together with the Treasury, we consulted on and made the necessary rules in time, including those related to the new 'Key Investor Information' document for consumers. Firms are currently in the process of introducing the document for investors (there is a year's transitional period).

We adapted a number of our internal processes to run alongside the new requirements and continue to work with other EU regulators to secure common application of the legislation, including the new structural freedoms available to UCITS managers, such as the ability to establish UCITS funds in member states other than the manager's own.

AIFMD

The Alternative Investment Fund Managers Directive (AIFMD) will significantly alter the regulatory framework under which UK firms manage and/or market alternative investment funds domestically and across the EU. It will also affect the business model of other actors in the collective asset management process.

We provided input to the Treasury in the political negotiations on the 'level 1' Directive, which was published in the Official Journal of the European Union in June 2011.

The European Commission then asked ESMA to provide advice on the content of a wide array of implementing measures contained in the Directive. We chaired one of the groups drafting this advice, and the Commission published draft implementing legislation in March 2012.

We started the process of UK implementation of the Directive by publishing a Discussion Paper in January 2012.

Electronic Money Directive

We successfully implemented the second Electronic Money Directive (2EMD) on 30 April 2011. The issuance of e-money has been regulated since 2002. Our e-money Approach Document provides detailed information for electronic money issuers and an overview of how we have implemented the new regime.

Through the Electronic Money Regulations 2011 (EMRs) 2EMD aims to encourage the growth of the electronic money market. The EMRs introduce several new conduct requirements for all electronic money issuers and new authorisation/registration and prudential standards for electronic money.

Section

5

Delivering a reduction of financial crime

Introduction

One of our statutory objectives is to reduce the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime. We achieve this through: our ongoing regulation of authorised firms; participation in policy-setting bodies – including internationally; and through extensive liaison with law enforcement in the UK and overseas.

In our *Business Plan 2011/12* we set out our strategic approach to achieving our financial crime statutory objective by:

- deterring criminals from using the financial services industry;
- encouraging the regulated industry to strengthen its defences; and
- warning investors about the dangers they might face.

This chapter sets out how we delivered on our *Business Plan* aims, set out as:

- supervisory initiatives, including our general approach, systems and controls, anti-bribery and corruption; and
- other initiatives, including money laundering, unauthorised business and working with other bodies to combat financial crime.

Supervisory and thematic work

In 2011/2012 we continued our intensive and intrusive approach to supervision. We published thematic reports and guidance for firms in relation to actions they can take to counter the risk that they might be used to further financial crime. We used our enforcement tools to alter behaviour and take appropriate action against authorised and unauthorised business. This included the largest fine yet imposed by us for financial crime failings in a firm. We also continued to educate consumers about the risks of investment fraudsters, and we continued to work with our domestic and international partners to tackle financial crime.

We held a very successful biennial Financial Crime Conference in June 2011, attended by over 350 delegates from law enforcement, other regulatory bodies and industry professionals. The

event provided a forum for us to engage with interested parties within the industry and outside, provided an update on our thematic work, and highlighted topics of particular interest.

Systems and controls

The *Business Plan* stated that we will address financial crime systems and controls issues through enforcement activity and increasingly intensive, ongoing supervision of regulated firms, with support from our financial crime and intelligence specialists.

In December 2011 we published *Financial Crime: A guide for firms*. The guide aims to enhance firms' understanding of FSA expectations and provides examples of steps firms can take to reduce their financial crime risks. It includes illustrative case studies and examples of both good and poor practice. We will update the guide on an ongoing basis.

Excluding market abuse, we fined institutions and individuals a total of £15.95m for failures to comply with our requirements for the prevention of financial crimes such as bribery and corruption, and fraud.

We also continued to address financial crime systems and controls issues through intensive and intrusive supervision of regulated firms. In June 2011 we published thematic reviews on banks' management of high-risk money laundering situations and on the adequacy of lenders' systems and controls against mortgage fraud. The key findings of both reviews are set out below and incorporated into the guide. Both reviews highlight the importance of senior management involvement in ensuring effective crime prevention.

In March 2012 we published a thematic review on anti-bribery and corruption (ABC) systems and controls in investment banks. We have also published a consultation on the changes we propose to make to the guide in light of our review.

Tackling insurance fraud

In 2011/12 we fined and banned two individuals for insurance fraud.

John Folan was fined £195,117 and prohibited from carrying on regulated financial services. Mr Folan was a director and adviser at Key Mortgage Associates, a small mortgage and insurance intermediary in Brentwood, Essex. In a process known as 'churning', he submitted at least 54 applications for life assurance and protection policies in his name and in the names of family members, without their knowledge. In some cases Mr Folan falsified signatures.

We also prohibited Andrew Porter for misconduct as a broker and director of Porter Insurance. Mr Porter deliberately underinsured clients, retaining the surplus money for his benefit, and falsified documentation in the names of companies to mislead clients and recipient insurance companies.

The adequacy of lenders' systems and controls against mortgage fraud

Our report[10] *Mortgage fraud against lenders* shows that some progress has been made in recent years against mortgage fraud, with stronger defences being developed and recognition of the importance of cross-industry coordination. However, we also identified weaknesses common to many firms, such as:

10 www.fsa.gov.uk/pubs/other/mortgage_fraud.pdf

- some firms lacked clear reporting processes;
- there were weaknesses in panel management and the level of due diligence being conducted on third parties, such as solicitors, brokers and valuers;
- staff did not receive adequate training, remuneration structures did not take account of staff's contribution to preventing mortgage fraud, and/or underwriting and fraud investigation staff appeared stretched; and
- mortgage fraud controls were insufficiently scrutinised by compliance and internal audit.

We encourage firms to take note of our findings and of the good and poor practice examples highlighted in our report.

Tackling mortgage fraud

We imposed four fines and banned five individuals with regard to mortgage fraud. In August 2011, Michael Lewis, an FSA-authorised sole trader mortgage broker, was prohibited and fined £106,499 for breaching Threshold Condition 5 (Suitability). Mr Lewis knowingly submitted mortgage applications containing false and misleading information and used false documentation to support a fraudulent application.

Anti-bribery and corruption systems and controls in investment banks

Our report[11] shows that, although some investment banks had completed a great deal of work to implement effective anti-bribery and corruption (ABC) controls, the investment banking sector has overall been too slow and reactive in managing bribery and corruption risk. In particular, we identified the following weaknesses:

- Most firms examined had not properly taken account of our rules covering bribery and corruption, either before the implementation of the Bribery Act 2010 or after.
- Nearly half the firms in our sample did not have an adequate ABC risk assessment.
- Management information on ABC was poor, making it difficult for firms' senior management to provide effective oversight.
- Only two firms had either started or carried out specific ABC internal audits.
- There were notable issues in firms' dealings with third parties used to win/retain business.
- Many firms had recently tightened up their gifts, hospitality and expenses policies, but few had processes to ensure gifts and expenses in relation to particular clients/projects were reasonable on a cumulative basis.

The introduction of the Bribery Act 2010, and our visits, were the main triggers for many firms in our sample to review, or consider for the first time, their approach to ABC. We are considering whether further regulatory action is required.

11 www.fsa.gov.uk/static/pubs/other/anti-bribery-investment-banks.pdf

Tackling bribery and corruption

In July 2011, we fined Willis Ltd £6.9m for failings in anti-bribery and corruption systems and controls. These failings created an unacceptable risk that payments made by Willis to overseas third parties could be used for corrupt purposes, including paying bribes.

Willis failed to ensure that adequate due diligence was carried out to evaluate the risk and failed to establish and record an adequate commercial rationale to support its payments to overseas third parties. Willis did not review its relationships regularly to confirm whether they were still necessary and appropriate. Senior management did not receive appropriate management information during this period, which meant they were not in a position to assess the risk adequately.

Banks' management of high money-laundering risk situations

Our *Business Plan* set out plans to publish a thematic report on how banks dealt with high-risk customers. Our report[12], published in June 2011, highlighted concerns with banks' relationships with politically exposed persons (PEPs) and other high-risk customers, correspondent banking relationships and wire transfer payments. The review found:

- Nine of the 27 banks we visited appeared unwilling to turn away, or exit, very profitable business relationships, including with PEPs, when there appeared to be an unacceptable risk of handling the proceeds of crime.
- Over half of the banks we visited failed to apply meaningful enhanced due diligence measures in higher risk situations, including establishing customers' source of wealth and source of funds.
- More than a third of banks visited failed to put in place effective measures to identify customers as PEPs.
- Some banks' anti-money laundering risk-assessment frameworks were not sufficient.
- At over a third of the banks visited, the management of customer due diligence was inadequate and some banks were unable to give us an overview of their high-risk or PEP relationships easily. This seriously impeded their ability to assess money laundering risk on a continuing basis.

We have serious concerns about the weaknesses we found in systems and controls and questionable judgements made by the firms, including inadequate steps by senior management to mitigate the risks. As a result of this and other work on anti-money laundering (AML) systems and controls, we have taken enforcement action against one firm and a number of banks are now under formal investigation.

Tackling anti-money laundering

On 26 March 2012, we fined Coutts & Company £8.75m for failing to take reasonable care to establish and maintain effective AML systems and controls relating to high-risk customers, including PEPs. The failings at Coutts were serious, systemic and were allowed to persist for almost three years. This resulted in an unacceptable risk of Coutts handling the proceeds of crime. This fine was the largest yet imposed by the FSA in relation to financial crime systems and controls.

12 http://www.fsa.gov.uk/pubs/other/aml_final_report.pdf

In November 2011 we started a thematic review to assess how banks mitigate against the risk posed by investment fraudsters, such as fraudulent share sale and landbanking schemes.

Core Financial Crime Programme

We are developing a Core Financial Crime Programme (CFCP), focusing on AML, countering terrorist finance (CTF) and financial sanctions, with the aim of ensuring that the we are discharging our statutory responsibility to secure regulated firms' compliance with UK legislation on these regimes. The CFCP is designed to extend to these risks the systematic, more intensive and intrusive approach that is now a key part of our supervisory philosophy. It focuses on a group of very large banks that, by virtue of their size and range of business, pose the highest level of AML/CTF and financial sanctions risk.

Unauthorised business

In 2011 we received 5,401 reports from consumers who had been contacted by boiler rooms, of whom approximately 14.3% had been victims (compared with 18.4% in 2010). We believe these reports represent a fraction of the approaches made to people about these frauds. We estimate that this activity leads to losses for UK consumers of approximately £200m each year. We have undertaken direct investigations and intelligence provided by us has also produced valuable input into successful operations by other law enforcement agencies. These cases have generated a great deal of publicity, helping to raise public awareness of investment fraud among investors.

In August 2011, Tomas Wilmot and his two sons were sentenced to nine, five and five years in jail, respectively, for boiler room fraud at Southwark Crown Court. The successful prosecution by the Crown Prosecution Service followed a long running and detailed investigation by the FSA, the City of London Police and Eurojust. The court found that the three Wilmots conspired to acquire, transfer and sell millions of low value, worthless and sometimes non-existent shares to victims in the UK.

Working with others to combat financial crime

We continued to work with the Treasury, HMRC, the National Fraud Authority (NFA), the Serious Fraud Office, the Serious Organised Crime Agency, and other organisations in the fight against financial crime. We liaised with industry, various trade bodies and law enforcement partners to obtain outcomes consistent with our financial crime statutory objective.

These relationships, and the intelligence they provide, have been critical to ensuring that we are able to keep undesirable people out of the financial services industry. We will continue to build on this work.

In October 2011, the NFA published its new four-year strategy, Fighting Fraud Together, which will form a key element of the work of the National Crime Agency's Economic Crime Command. We were one of many signatories to the strategy. As part of the working programme, we hosted a symposium for law enforcement and other agencies to discuss the risk posed to the UK public by landbanking. This is detailed further on page 61.

In our *Business Plan 2011/12*, we set out our aim to promote and further embed a proportionate, risk-based approach to AML, by influencing the Financial Action Task Force (FATF)'s review of its standards. In February 2012, FATF adopted revised recommendations[13] for anti-money laundering and counter-terrorist financing, most of which are underpinned by the risk-based approach.

13 www.fatf-gafi.org

Section 6

Delivering the FSA's operational platform

Introduction

During 2011/12, as set out in the *Business Plan*, we have continued to focus on the quality and capability of our staff, improving our IT infrastructure and delivering successful programmes and projects. This has supported the delivery of our statutory objectives and our internal preparations for the creation of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

We have built our capabilities by recruiting talented and experienced people, both at senior leadership levels and below, and by providing appropriate training and development opportunities.

We have prioritised our portfolio of projects and programmes, enabling us to meet the additional demands of regulatory reform. We have developed our technical infrastructure to meet new data collection and reporting requirements and to improve the reporting and monitoring of firms that we regulate.

Our people

Resourcing

We continued to recruit and retain a diverse range of talented people by positioning the FSA as an employer of choice and exploiting the opportunities created by the regulatory change. Acceptance rates remained high, with 88% of offers made to all applicants in 2011/12 being accepted.

A total of 215 hires were recruited into supervisory areas alone this year from a wide range of backgrounds. Our graduate and MBA programmes continue to be successful and provide a pipeline of talent for the future.

We reorganised our people into a new structure that more closely resembles our successor bodies. Martin Wheatley joined as FCA CEO Designate, heading up our Conduct Business Unit, and we filled 19 newly created Head of Department roles. We also recruited a further six Heads of Department and three Directors (Director of Communications, Director of HR and Director of Authorisations) to fill existing role vacancies.

FSA staff levels and turnover, years ending March 2008 to March 2012

Financial year	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012
Total headcount~	2,665	2,949	3,431	3,909	3,955
Staff turnover^	13.0%	6.9%	4.9%	10.4%	9.8%

~ full-time equivalent of FSA staff as at the last day of the period
^ annual turnover rate for permanent employed staff

Training and development

We have continued to deliver our commitment to enhance the technical skills of our supervisors to ensure that confidence in regulation of the UK financial system is maintained.

We continued the phased roll-out of our training and competence scheme across the FSA. The scheme defines the technical and behavioural competence required of staff in different roles and is used to identify and manage gaps in knowledge or skills. We have now embedded the scheme into the way we assess and manage performance. We have also added further training modules to the suite of technical training we developed for supervisors following the financial crisis.

To prepare for the move from integrated to the 'twin peaks' model of regulation within the FSA from April 2012 we rolled out dedicated training to our supervisors to equip them with the information and skills needed to operate the new supervisory approach effectively.

Given the international nature of regulation, and in particular the European Supervisory Authorities' (ESAs) growing regulatory powers, we have focused closely on supporting staff engagement with the ESAs and other regulatory organisations. This has resulted in a number of strategic European and Global secondments, including staff placements at the ESAs, the European Commission, EU Parliament, the Basel Secretariat and the International Organization of Securities Commissions (IOSCO), and a pipeline of further potential placements. We also collaborate with other regulators in Europe by sharing best practice on training and allowing access to our technical training.

We have actively developed our leadership and management competencies, particularly focusing on collaborative working, to help us deliver against the challenges of regulatory reform. We continued to run our Executive Development Programme for our senior leaders and our Management Development Programme for aspiring managers, ensuring we develop a pipeline of future leaders.

Programme and project delivery

We prioritised our portfolio of projects, focusing on those projects and programmes that are non-discretionary (for example, projects to implement new EU legislation) and those that are critical to deliver the objectives of the FSA and its successor organisations. This enabled us to meet the additional challenges and demands of regulatory reform.

Programme deliverables include:

- delivering a programme to implement new rules, systems and controls, and reporting requirements for firms as part of the new liquidity regime;

- implementing a strengthened regulatory regime for the protection of client money and assets; and
- developing systems to support e-money regulation.

We strengthened our programme management and IS functions to ensure that projects and programmes were able to deliver quality outputs on time and on budget. We have run deep-dive delivery assurance on projects and programmes to ensure that they proceeded to plan and have enhanced the skills and capabilities of our project and programme delivery staff by undertaking skills assessments and providing appropriate training. We have improved our effectiveness and capability in IS by converting a number of contractor roles to permanent positions while retaining some flexibility in our staffing model, allowing us to adapt to a changing portfolio of work.

Technical infrastructure

We have continued with our work to modernise our technical infrastructure. Key achievements in the last year include the upgrade of our supervisory database and risk management system, enhancements to the way we manage digital evidence as part of our Enforcement investigations and the launch of our Surveillance Analysis of Business Reporting System (SABRE/ZEN) (see page 47 for more details). We have also improved the way we store and share our knowledge internally and rolled out improved technology in our customer contact centre.

In 2010 we launched a strategic outsourcing framework agreement (SOFA) to develop relationships with new and existing suppliers and enhance the scope of services we outsource. In 2011/12 we used SOFA to undertake tenders for a number of IS requirements, including application development, application maintenance, software supply and the provision of infrastructure. Embedding SOFA has enabled us to widen the number of suppliers bidding for our IS requirements in a controlled way, ensuring we achieve the best value for money.

Section 7

Financial review

Basis of preparation

This financial review is based on our Financial Management and Reporting Framework as set out in our *Business Plan* for 2012/13. We use this framework for internal management purposes to help monitor and manage our resources. The framework is also designed to reduce the impact on fees of short-term volatility in our costs. Under this framework, net expenditure on core operating activities is identified as our Ongoing Regulatory Activities (ORA) expenditure.

Table 7.1: Reconciliation of statutory accounts to the financial review

	£m
Net expenditure for the year per the statutory accounts	**470.0**
Add: Taxation	0.4
Net expenditure for the year including taxation per the statutory accounts	**470.4**
Add: difference between accounting charges for pension provisions in the statutory accounts and the related cash costs of pension contributions paid	15.3
Add: advanced funding received in respect of Transactional Reporting System (TRS) and UKLA	3.5
Less: scope change	(3.1)
Less: cost of regulatory Reform implementation	(11.4)
Net ORA expenditure for the year	**474.7**

Net ORA expenditure

Our net ORA expenditure for the year to 31 March 2012 was £474.7m, resulting in a net surplus of £17.3m against the original budget of £492.0m.

The £17.3m surplus compared to budget reflects our original CEO contingency not required (£8.4m) and a business as usual surplus of £8.9m (1.8% of ORA). The CEO contingency was established to cover both economic and business contingencies. Macro-economic risks, in terms of extreme regulatory and supervisory events identified at the time of the planning round, have not materialised and business risks have been absorbed in local budgets and so the contingency was not spent.

We also spent £11.4m on regulatory reform implementation and £3.1m on activities that represented additional scope for the FSA. This included work on RDR (professionalism requirements), Alternative Investment Fund Managers Directive (EU Legislation) and Northern Ireland Credit Union (new regulatory framework applying to credit unions in Northern Ireland). Costs are to be recovered in future years from entities specifically aligned to these initiatives once they have been implemented.

The tables below analyse in more detail the actual and budgeted costs for 2011/12 by cost type and function. The budget reflects the reallocation of funds between business units, to ensure

resources are available for priorities as they emerge throughout the year and facilitate the comparison between actual and budgeted results.

Table 7.2: Net expenditure by type

	2011/12 Actual £m	2011/12 Budget £m	2011/12 Variance £m
Staff costs (including travel, training, recruitment and pension scheme deficit reduction contributions)	347.9	360.2	12.3
Accommodation, office services and depreciation	68.5	65.9	(2.5)
IT costs (including IT delivery outsourcing)	61.5	60.8	(0.7)
Professional fees	17.0	23.9	6.9
Printing, publications and other	15.9	8.6	(7.3)
	510.7	519.4	8.7
Sundry income	(36.0)	(27.4)	8.6
Total net ORA expenditure	474.7	492.0	17.3

Staff costs were £12.3m lower than budget reflecting challenges to recruit permanent specialist resources in both Prudential and Conduct business units and the impact of changing our resource profile in readiness for the cutover to the future regulatory authorities.

Accommodation, office services and depreciation were £2.5m over budget due to the acceleration of the SABRE ZEN programme which resulted in an earlier than planned depreciation charge.

IT costs were £0.7m over budget mainly caused by the impact of impairments to capitalised software, following the introduction of SABRE ZEN.

Professional fees were £6.9m below budget, principally representing the fact that the CEO contingency fund of £8.4m was not utilised as the macro-economic risks identified at the time of the budget did not materialise and the fact that business risks were absorbed within delegated budgets.

Printing, publications and other costs were £7.3m over budget due to the costs of additional external Enforcement case work.

Sundry income was £8.6m over budget reflecting greater project activity and higher project cost recoveries in the Operations business unit than anticipated.

Table 7.3: Net expenditure by business unit

	2011/12 Actual £m	2011/12 Budget £m	2011/12 Variance £m
Conduct	147.9	147.6	(0.3)
Prudential	168.9	173.4	4.5
Operations	50.3	45.3	(5.1)
Other Central Services*	68.3	85.4	17.1
Enforcement and Financial Crime	75.4	67.7	(7.6)
	510.7	519.4	8.7
Sundry income	(36.0)	(27.4)	8.6
Total net ORA expenditure	474.7	492.0	17.3

* Other Central Services comprise Chairman's and CEO's Offices (including Corporate Services area, Specialist Supervision Unit and Strategy, Planning and Performance), General Counsel's Division, Risk & Financial Stability Division, Communications and Internal Audit.

The Conduct over-spend reflects the unbudgeted costs of the SABRE ZEN project and TRS disposal (cost recoveries for these projects are included in sundry income). The additional project costs are offset by an under-spend on staff costs, caused by the realignment of staffing resources in anticipation of the new organisational structure.

The Prudential under-spend reflects the changing resourcing profiles as we re-align the business in readiness for the division of responsibilities between the future successor bodies.

The Operations over-spend reflects additional SABRE ZEN depreciation charges caused by the project going live earlier than budgeted and the additional charge for related asset impairments.

The under-spend in Other Central Services is partly due to the CEO contingency fund not being required and divisional under-spends as a result of re-aligning resources and priorities in anticipation of legal cutover. Included within this business unit are panel costs and costs related to the Complaints Commissioner.

Panel costs include the cost of the Consumer Panel (£0.7m) and the combined cost of the Practitioner and Smaller Businesses Practitioner Panels (£0.1m). These figures include the costs of: staff that support the Panels' work; independent research; Consumer and Small Business Practitioner 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.

The FSA provides funding for the Office of the Complaints Commissioner (OCC) which incurs costs in relation to the Commissioner and his staff, accommodation and ancillary services. The OCC's total costs for 2011/12 were £0.6m, in line with budget.

Enforcement and Financial Crime cost over-spend reflects additional external enforcement case costs and includes the cost of external accountants and lawyers of £9.6m for 2011/12 (£8.8m in 2010/11), brought in to assist with large or complex enforcement cases. Some of the costs of enforcement cases were recovered from the firms involved and these are included separately within Sundry Income.

As in previous years, we neither budget for penalties arising from disciplinary cases nor use them to fund our activities. During 2011/12 we collected penalties of £70.7m (2010/11 £86.2m), which will be used to reduce the fees levied by us across relevant fee blocks in future years.

Funding

We are funded by fees payable by the organisations we authorise, recognise, register or list. During 2011/12, £505.9m in fees was raised directly from those fee-payers (2010/11: £464.2m).

In addition to the £492m ORA funding (2010/11 £450.8m), a further £13.9m of fees were collected. These comprised: £10.9m for Regulatory Reform; £5.0m for outcomes-focused regulation transition; £1.6m to fund scope change; and £5.4m additional fees (resulting from firm population and tariff data changes) offset by a net £9.0m Annual Funding Requirement movement in reserves.

Table 7.4: Funding the FSA's net expenditure

	2011/12 £m	2010/11 £m
Total net costs for the year per the financial review	474.7	450.8
Under-spend against budget (see reserves movement – Table 7.5)	17.3	7.2
ORA Budget	**492.0**	**458.0**
Additional funds raised		
Regulatory Reform	10.9	0.0
Outcomes-focused regulation transition	5.0	5.0
Scope change funding	1.6	2.7
Additional fees	5.4	8.2
Movement of reserves to fund AFR reduction	(9.0)	(11.0)
Money Advice Service periodic fees collected	0.0	1.3
	13.9	**6.2**
Fees income per statutory accounts	505.9	464.2

Balance Sheet

Financial strength

The FSA had net liabilities of £66.1m at 31 March 2012, primarily as a result of pension liabilities of £107.1m, calculated under International Accounting Standard 19: Employee Benefits (IAS 19). Excluding the pensions deficit, the FSA had a net surplus of £41.0m.

The pension liabilities will not crystallise for many years and our approach to managing them and to funding our pension deficit is explained in note 15 to the financial statements.

The FSA's current borrowing facilities total £151.0m, comprising two revolving credit facilities (RCFs) of £75.0m each with Lloyds Banking Group (LBG) and HSBC respectively, and a £1.0m overdraft facility with LBG. These credit facilities provide short-term additional capacity to fund

our activities. The FSA is in the process of renewing the HSBC RCF and the LBG overdraft and has every expectation of renewing these facilities on similar terms.

As at 31 March 2012 the FSA had £72.0m of cash and cash equivalents (31 March 2011: £100.1m) and our average cash balance was £163.9m in 2011/12 (2010/11: £172.5m). The FSA also has available to it as working capital, the penalties levied during the year as these monies are returned to firms (excluding those fined) through the following year's fee raising cycle.

In addition, the FSA has strong fee covenants and a predictable cash flow/ working capital profile. The invoicing of firms is undertaken in three main tranches across 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 has been set at a period of six weeks' ORA expenditure (£61.8m for 2012/13).

Financial management of the FSA's pension costs

Our pension plan has two sections, Final Salary and Money Purchase. The Final Salary Section has been closed to new members since 1 June 1998, other than staff transferring from previous regulators whose activities we have taken on. Since 1 April 2010, the Final Salary Section has been closed to future accruals as part of the FSA's move to a new reward platform and there have been no active members since that date. At 31 March 2012 there were 1,624 (31 March 2011: 1,665) Deferred Final Salary members and 405 (31 March 2011: 400) in receipt of pension. The Final Salary Section is relatively immature compared to many such schemes, in that just over 19% of members of the Final Salary Section are pensioners. At 31 March 2012 there were 3,557 (31 March 2011: 3,359) staff in the Money Purchase Section.

Overall the pension deficit has reduced by £7.4m to £107.1m (2011 £114.5m).

Key factors impacting the change in value of our pension deficit are:

- an increase in the value of assets of £45.5m arising from contributions and investment performance;
- a gain arising from the change in the inflation assumption from 3.50% to 3.30% that reduced the deficit by £22.3m;
- the corporate bond discount rate reduced from 5.60% to 5.25% and increased the deficit by £31.7m;
- a change in commutation terms and assumptions that increased the deficit by £4.1m; and
- interest costs of £25.0m that increased the deficit.

We continue to work with the Trustee of the Final Salary Section of the Plan to secure the pension benefits of our employees and mitigate the risks arising from the Plan. We believe that our approach to the management of our pension costs strikes an appropriate balance between our obligations to our staff and fee-payers. We will keep our approach under review.

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 relatively limited level of reserves 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 7.5: Reserves/(Deficits) movements

	ORA reserve £m	Scope change £m	Outcomes-focused regulation transition reserve £m	Advanced Funding £m	Regulatory Reform £m	Pension Reserve £m	Total £m
At 1 April 2011	10.3	(3.5)	(5.0)	19.0	0.0	(114.5)	**(93.7)**
Annual Funding Requirement	(9.0)	1.6	5.0		10.9		**8.5**
Additional fees	5.4						**5.4**
Net surplus	17.3						**17.3**
Regulatory Reform Cost					(11.4)		**(11.4)**
Movement in Advanced Funding				3.5		7.4	**10.9**
Costs relating to scope change		(3.1)					**(3.1)**
Total movement for the year	**13.7**	**(1.5)**	**5.0**	**3.5**	**(0.5)**	**7.4**	**27.6**
Total statutory reserves at 31 March 2012	**24.0**	**(5.0)**	**0.0**	**22.5**	**(0.5)**	**(107.1)**	**(66.1)**

The net reserve deficit has reduced from £93.7m to £66.1m during the year.

ORA reserves

Our ORA reserves at 31 March 2012 were £24.0m (2010/11: 10.3m). £10.6m (2010/11: £9.0m) of this reserve will be used to fund our commitment to reducing the fees we need to collect in 2012/13. The remaining £13.4m is being carried forward as an ORA reserve.

Scope change

Costs related to scope changes of £3.1m have been separately identified. The accumulated expenditure of £5.0m will be recovered in future years from appropriate fee blocks.

Outcomes-focused regulation transition

The remaining deficit on this programme has been recovered during the year, reducing the balance to £nil (2010/11: £5.0m).

Advanced funding

The advanced funding reserve separately identifies funds collected for specific projects/activities principally related to UKLA and other markets-related activities. The increase is driven by the net sales proceeds from the disposal of the Transaction Reporting System being held in reserves to offset against future markets monitoring-related expenditure.

Regulatory Reform

We expect the Regulatory Reform Programme to be in line with budget over the course of its life.

Financial Management and Reporting Framework

The scope of activities that fall within our remit is wide and varied. This includes some activities that are intended to be temporary and/or are subject to considerable variation from year to year. We cannot forecast these with the same reliability as regular recurring activities. We will continue to:

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

Our Board believes it is helpful to have a framework within which to manage and report on our costs and funding. The following streams of activities which have distinct cost and funding characteristics have been identified.

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 (increase or decrease)

Under certain circumstances, including legislation introduced by Parliament, there may be changes to the scope of activities that we regulate. Any scope changes, as with our other core operating activities, are subject to financial management as part of our budget process. However, until the supervisory process is established, material activities resulting from a scope change are controlled separately so they are individually identifiable. When the 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.

Exceptional items

We include these costs within the cost of our ORA and will report on material movements from year to year.

External enforcement costs

Total enforcement costs depend on the number of cases and their complexity. We will continue to manage these costs and seek to optimise the mix of internal and external enforcement resources when we do this. We have included these costs within the cost of our ORA and we will report on any material movements from year to year.

Whilst we will maintain strong financial management of these costs, the actual amounts may be materially higher or lower than the budgeted level 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

The Financial Services Consumer Panel and the Practitioner Panel have a status under Financial Services and Markets Act 2000 (FSMA) that guarantees their independence from the FSA. These bodies and the Smaller Businesses Practitioner Panel manage their own costs against budgets. They are, however, subject to our approval and are funded through our fees. These costs are included within the cost of our ORA.

Office of the Complaints Commissioner

FSMA requires that an arrangement is in place for the investigation of complaints against the FSA. The Complaints Scheme was introduced in September 2001. FSMA requires us to ensure that the Complaints Commissioner has at his disposal the resources to conduct a full investigation of any complaints. The Complaints Commissioner controls his own costs against a budget which is subject to our approval and is funded through our fees. These costs are included within the costs of our ORA.

Pension scheme deficit reduction contributions

The amounts required to fund our pension liabilities over time are inherently variable, and depend on several variable factors, including current investment values and projected investment returns. We have plans in place to reduce this 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 current 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 maintain the equivalent value of six weeks of our ORA as a contingency fund. 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 our 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, regulatory reform risk and the risk arising 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 those risks and taking appropriate mitigation action where required. FSMA 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 those fees.

The Board has delegated the responsibility of monitoring financial risk management to the Audit Committee. The policies set 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. 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, LBG, in high quality, liquid deposits (thus eliminating any price risk) 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 meet our minimum investment criteria as assigned by credit rating agencies.

Final salary pension scheme

Our 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 FSA. What we are doing to manage those risks is set out in note 15 to the financial statements.

Currency risk

We do not have any significant exposure to currency risk.

Section 8

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The Board of the FSA*

1. **Peter Fisher**
Non-executive Director

2. **Dame Sandra Dawson**
Non-executive Director

3. **Hector Sants**
Chief Executive

4. **Mick McAteer**
Non-executive Director

5. **Karin Forseke**
Non-executive Director

6. **Adair, Lord Turner**
Chairman

7. **Iain Brown**
Company Secretary

8 **Brian Pomeroy**
Non-executive Director

9 **James Strachan**
Non-executive Director

10 **Margaret Cole**
Executive Director

11 **Andrew Scott**
Non-executive Director

12 **Paul Tucker**
Non-executive Director

13 **Brian Flanagan**
Non-executive Director

14 **Martin Wheatley**
Managing Director,
Conduct Business Unit

15 **Amanda Davidson**
Non-executive Director

* As at 31 March 2012

Directors' Report

Throughout the Directors' Report, references are made to our website. The full addresses are given in Table 1.

Table 1

Retail Conduct Risk Outlook 2012	www.fsa.gov.uk/pubs/other/rcro12.pdf
Business Plan 2012/13	www.fsa.gov.uk/static/pubs/plan/bp2012-13.pdf
Corporate Responsibility	www.fsa.gov.uk/Pages/About/What/cr/index.shtml
Health & Safety	www.fsa.gov.uk/pubs/staff/staff_handbook.pdf
Equal Opportunities	www.fsa.gov.uk/pubs/staff/staff_handbook.pdf

Table 2

Name	Board meetings	Additional Board Meetings*	NedCo	RemCo	AuditCo	RiskCo	Original appointment date	Expiry of current term
Margaret Cole	10/11	1/1					7. 9.10	31. 3.12
Amanda Davidson[d]	11/11	1/1	5/5		4/4		1. 5.10	30. 4.13
Sandra Dawson[d]	11/11	1/1	5/5	3/3	4/4		1. 5.10	30. 4.13
Carolyn Fairbairn[b & d]	8/8	1/1	2/4			3/3	11.12.07	31.12.11
Peter Fisher[b & d]	10/11	0/1	5/5			4/4	19. 1.07	17. 1.13
Brian Flanagan[b & d]	11/11	1/1	5/5	2/3	3/4		19. 1.07	17. 1.13
Karin Forseke[c & d]	11/11	1/1	5/5	3/3	4/4		1.12.04	31. 8.12
Mick McAteer[d]	11/11	1/1	5/5			4/4	1.11.09	31.10.12
Brian Pomeroy[a & d]	11/11	1/1	5/5		4/4		1.11.09	31.10.12
Hector Sants[c]	11/11	1/1					4. 5.04	30. 6.12
Andrew Scott[d]	11/11	1/1	3/5			3/4	1.11.09	31.10.12
James Strachan[d]	11/11	0/1	5/5	3/3	4/4		1.11.09	31.10.12
Paul Tucker[b & d]	9/11	1/1	2/5			1/4	1. 3.09	***
Adair Turner	11/11	1/1					20. 9.08	19. 9.13
Martin Wheatley	7/7	1/1					1. 9.11	31.08.14

Key
a Chair of the FSA Pension Plan Trustee Ltd
b Director serving second concurrent term
c Director serving third concurrent term
d Independent non-executive director

Committee membership during the year:

Audit Committee (AuditCo)
Amanda Davidson**
Sandra Dawson
Brian Flanagan
Karin Forseke (Chair of AuditCo)
Brian Pomeroy**
James Strachan**

Remuneration Committee (RemCo)
Sandra Dawson
Brian Flanagan
Karin Forseke (Chair of RemCo)
James Strachan

Risk Committee (RiskCo)
Carolyn Fairbairn (Chair of RiskCo until 31 December 2011)
Peter Fisher
Mick McAteer
Andrew Scott (Chair of RiskCo from 19 January 2012)
Paul Tucker

Committee of Non-executive Directors (NedCo)
All Non-executive directors are members of NedCo
Karin Forseke (Chair of NedCo)

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

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

*** The Deputy Governor, Financial Stability at the Bank of England is a member of the Board of the FSA. In a reciprocal arrangement with the Bank of England, the FSA's chairman serves as a member of the Court of the Bank of England. Paul Tucker's first term as a director of the FSA ended on 29 February 2012. In view of the regulatory reform proposals, HM Treasury reappointed Mr Tucker to the FSA Board until legal cutover, at which time the FSA will cease to exist.

The only members of the FSA are the directors. Each current director has undertaken to guarantee the liability of the FSA up to an amount of £1.

The executive directors are not directors of any UK-listed companies and have no other paid positions.

All the FSA's directors are appointed by the Treasury, with input on the selection panel from at least one incumbent member of the FSA Board. Although the FSA is not subject to the code of practice issued by the Commissioner for Public Appointments, appointments are made in line with the principles in the code.

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

The directors present their report for the year ended 31 March 2012.

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 7 sections of the Annual Report.

Principal activities

We are the primary regulator of financial services in the UK and have statutory responsibilities set out in the Financial Services and Markets Act 2000 (FSMA). Detailed information on our principal activities for the year can be found in sections 1 to 7 of this Annual Report.

Principal risks and uncertainties

Our principal risk is the failure to meet our statutory objectives.

Due to the Government's proposed regulatory reform, there are 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 our capacity to deliver against our current FSMA obligations. The Board has regularly reviewed the executive's strategy to mitigate these risks, which is led by a high-level transition committee, and will continue to scrutinise and challenge the plan to ensure operational risks are minimised. All identified risks and uncertainties are 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 our 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. Information on proposed future developments can be found in the Business Plan for 2012/13 which is available on our website and provides information relating to our budget and priorities.

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 2012 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 hence for taking reasonable steps for preventing and detecting 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

Our primary source of income is the fees charged to regulated firms. Specific information on our financial position is provided in the Financial Statements and in the Financial Review. The Financial Review explains how we manage our pensions liabilities. The directors agree with the analysis in the Financial Review and believe we are able to meet our liabilities as they fall due.

Going concern

The FSA is an independent body that regulates the financial services industry in the UK. Our powers and objectives are given to us by FSMA and we also aim to promote efficient, orderly and fair financial markets and follow our principles of good regulation. The business activities of the FSA during the last 12 months are summarised in the chief executive's report. The directors have considered the following risks and uncertainties in reaching a conclusion on going concern as set out below:

i. **Liquidity risk:** The FSA's strong fee covenants are underpinned by the statutory powers granted to it under FSMA to raise fees to fund its regulatory activities. Of the authorised firms on which the FSA currently levies its fees, the top one hundred firms are responsible for 60% of those fees. The FSA is also well placed from a liquidity perspective, with £71m in cash reserves at 31 March 2012 and available and undrawn borrowing facilities of £151m. The FSA is in the process of extending one of its revolving credit facilities with a value of £75m which expires on 27 May 2012 and its £1m overdraft facility which expires on 30 June 2012 and has every expectation that these facilities will be renewed at appropriate commercial terms.

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

   a. the collection of fees from the financial services industry: the FSA 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 counterparties: 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.

iii. **Regulatory reform risk:** The transition to the new regulatory authorities is a complex process and there will be a number of operational and financial consequences associated with the process. Set out in note 19 to the financial statements is a summary of the contingent liabilities that we anticipate will crystallise as part of the regulatory reform process. These costs have already been anticipated as part of our annual budgeting process. This risk is significantly reduced for the FSA as the legal entity continues throughout, with a name change to the FCA. Furthermore, we are not anticipating anything in the legislation that will affect the FCA's ability to raise funding (as the FSA does currently) and hence meet its statutory objectives.

iv. **Significant accounting judgements, estimates and assumptions** 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 15 to the financial statements.

Having regard to the above, it is the directors' opinion that the FSA 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 the use of the going concern basis is appropriate as there are no material uncertainties related to events or conditions that may cast significant doubt about the FSA's ability to continue as a going concern.

Corporate responsibility

The FSA plays a key role in protecting and enhancing the integrity and stability of the UK financial system. As such we consider it very important that we take our corporate citizenship seriously and lead by example to influence positive change not only within the FSA but also among the financial services industry.

In order to provide an effective and efficient regulatory service, we need to ensure that we recruit, develop and retain the most talented, engaged and diverse workforce that we can. In order to provide the best service to the public and to the financial sector, we need to support staff to understand, represent and have close links with both the marketplace and the wider community. In this way we can be in the strongest position to fulfil our obligations and role.

Corporate responsibility has three main objectives:

- to make the FSA an employer of choice;
- to ensure we safeguard all our resources; and
- to support staff to understand the communities we serve.

People

We are committed to promoting equality and diversity and creating a positive culture in all areas of our work as an employer and a regulator, where differences are recognised and supported. We have policies that outline our approach to equality, diversity and inclusion, flexible working, career development and wellbeing. Each of these emphasises our commitment to our people. We have key performance indicators which focus on these areas. Performance, where possible, is measured and reported in the corporate responsibility section of our website. We continue to review and develop measures for those areas that are not currently assessed.

Environment

We are conscious of the impact of our operations on the environment and the increasing expectation that organisations should manage this impact. We aim to reduce CO_2 emissions, energy use, water and the waste we produce, as well as increase the amount of waste that is recycled. To achieve this we seek to raise awareness of environmental issues among our staff. We set targets in each of our key impact areas, and these are measured and reported on in the corporate responsibility section of our website.

Community

As well as an opportunity to engage within the wider community and have a positive impact, staff are encouraged to view volunteering as a tool to assist them in their personal development. It can also be seen as an opportunity to gain a better understanding of the community that will enhance their interactions with those we regulate and increase the insight and quality of our regulatory policies and process.

Equality and diversity

We are committed to the principles of equality, diversity and inclusion and further information about our work in these areas is contained in the Appendices to this Annual Report.

Employee involvement

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

The Staff Consultative Committee is the forum through which we comply with the Information and Consultation of Employees Regulations 2004. It also provides a clear channel of communication and consultation between the FSA and our staff. It gives 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. We recognise the importance and value of ensuring this process happens effectively.

Employee training

Employees are given opportunities to undertake a variety of in-house and external training and, during the year, each employee spent an average of 6.29 days training (6.5 days in 2010/11).

Charitable donations

The FSA did not make any charitable donations during the year 2011/12.

Health and safety

We are committed to providing a healthy and safe environment. We pursue a policy to promote health and safety at work and seek the cooperation of all employees and visitors in this endeavour.

Creditor payment policy

Our policy is to aim to pay 90% of valid invoices with a correct purchase order within 30 days of receiving them. The average time taken to pay suppliers from receipt of invoice was 24 days in 2011/12 (30 days in 2010/11).

Auditor

The National Audit Office was appointed as auditor of the company at a General Meeting on 1 July 2010 and was the auditor throughout the 2011/12 financial year.

By Order of the Board

K Iain Brown
Secretary
24 May 2012

Corporate governance statement for the year ended 31 March 2012

Table 3

Accountability mechanisms	www.fsa.gov.uk/Pages/About/Who/Accountability/index.shtml
Role of Chairman	www.fsa.gov.uk/pages/About/Who/Management/Chairman.shtml
Role of Chief Executive	www.fsa.gov.uk/pages/About/Who/Management/CEO.shtml
Schedule of matters reserved to the Board	www.fsa.gov.uk/pubs/other/SoM.pdf
Board delegations including terms of reference of the committees	www.fsa.gov.uk/pubs/other/Gov_memo.pdf
Directors' biographies	www.fsa.gov.uk/Pages/About/Who/board/index.shtml
NedCo, RemCo, AuditCo and RiskCo membership	www.fsa.gov.uk/Pages/About/Who/board/committees/index.shtml
Regulatory Decisions Committee membership	www.fsa.gov.uk/Pages/About/Who/board/committees/RDC/index.shtml
Listing Authority Advisory Committee membership	www.fsa.gov.uk/Pages/About/Who/board/committees/laa/index.shtml

The FSA is a company limited by guarantee and, as such, is not obliged to comply with the UK Corporate Governance Code (the Code). However, FSMA requires us to have regard to generally accepted principles of good corporate governance as applicable. The Board is committed to meeting high standards of corporate governance and has decided that we should comply with the Code as far as appropriate. This report sets out where we comply with the principles in the Code.

We are required by FSMA to have a number of accountability mechanisms, including an Annual Public Meeting and the requirement to report on the extent to which our regulatory objectives have been met. We are funded by the industry we regulate through our statutory fee-raising powers and we operate independently of Government, but are accountable to Parliament through Treasury ministers. We are required to consult on our rules and general policy with

consumers and practitioners and we do this through the Consumer, Practitioner and Smaller Businesses Practitioner Panels. More information about the accountability mechanisms can be found on our website.

We are led by a unitary Board, which develops our strategy and approves and monitors the annual operating plan and budget. There is a schedule of matters reserved to the Board and a governance memorandum setting out the delegation of various functions, which can be found on our website. The majority of the Board is made up of non-executive directors who, in addition to their statutory responsibilities under the Companies Act 2006, have specific obligations under FSMA. The Board is of sufficient size to ensure that the requirements of the business can be met and that changes to the Board composition and any of its committees can be managed without undue disruption. FSMA requires that there is a non-executive directors' committee (NedCo), which keeps certain functions under review. Information on NedCo's work is set out in the non-executive directors' report.

The Board meets regularly. Details of the number of Board and committee meetings held during the year and attendance at those meetings are set out in Table 2. The membership of the various committees can also be found in Table 2 and on our website.

The roles of the FSA chairman and chief executive are split, and their respective responsibilities are set out on the website. The chairman, who was independent on appointment in September 2008, leads the Board and ensures its effectiveness, and the chief executive develops and delivers the strategic objectives agreed with the Board.

In preparation for the future regulatory system the FSA moved to an internal twin peaks structure in April 2012. This involved the replacement of the Risk and Supervision Business Units with new Prudential and Conduct Business Units enabling us to test the future regulatory model before legal cutover. At that point the FSA will cease to exist and will formally split into the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The steps taken by the FSA to progress the regulatory reform programme are explained more fully in the Annual Report. Following the resignation of Hector Sants as chief executive with effect from 30 June 2012, the twin peaks structure will continue, with Adair Turner as executive chairman, until legal cutover to the new regulatory system.

The non-executive directors of the Board have a variety of appropriate skills and experience. Details of their backgrounds can be found on our website. Aside from any contact they may have with the FSA as a result of being connected with a regulated firm, or as consumers of regulated products, the non-executive directors are judged to be independent of the FSA. Where any conflicts of interest arise relating to personal or business matters, procedures are in place to ensure that no director is exposed and that decisions are made without undue influence.

The chairman ensures, with the company secretary, that the Board's agendas are set in line with the priorities of the company. The company secretary reviews papers before they are circulated to Board members to ensure that information is accurate and clear. Papers for Board and Committee meetings are usually circulated one week before meetings.

One of the non-executive directors acts as chair of the non-executive directors' committee, and is viewed as the senior independent director.

Directors of the FSA are formally appointed by the Treasury following a rigorous selection process. The selection panel comprises representatives of both the FSA and the Treasury. Although the FSA is not subject to the code of practice issued by the Office of the Commissioner for Public Appointments, the procedures followed are in line with the principles in the code.

When directors are appointed, the company secretary arranges an induction that is appropriate for their knowledge and experience. The Board receives ongoing professional development on issues that are relevant. During the last year this included training for non-executive directors on Solvency II, platforms, client assets and the Mortgage Market Review. Individual directors have also had personal briefings on other topics before Board meetings.

Each director has access to the advice and services of the company secretary, who also advises the Board on all aspects of governance matters. The company secretary will provide access to external professional advice for directors, if required.

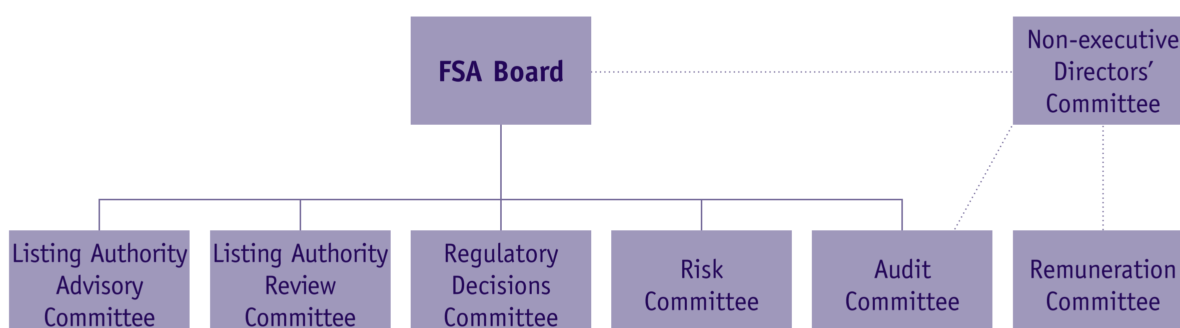
Due to its statutory nature, the FSA benefits from immunity under FSMA in respect of legal action, which it supplements with indemnities in favour of individual directors. The Board therefore regards insurance in respect of legal action against directors as unnecessary.

During the year, and the early part of 2012, a number of evaluations relating to the Board, its members and committees were carried out. The effect of the Government's proposals for the reform of financial services in the UK, when implemented, will include replacing the FSA with two new organisations, the PRA, which will be a subsidiary of the Bank of England, and the FCA. Both new organisations will have Boards to oversee their operation and, although their composition and responsibilities will only be confirmed once the current legislative process is complete, the Board considered it important to review what lessons could be learned for the remaining tenure of the FSA and for the future operation of the FCA. The evaluation of the Board was facilitated by external consultants.

In September 2011, the Board established a sub-group to support the executive in the development of the FCA. The sub-group is chaired by the FSA chairman and the other members are all non-executive directors. The sub-group, which is advisory in nature and has no delegated decision-making duties or powers, is responsible for providing support and challenge to the CEO designate of the FCA to ensure the FCA is developed as a fit for purpose successor to the FSA.

The chair of NedCo led a review of the chairman's performance, taking input from key stakeholders and Board members and feedback was provided to the chairman.

Governance structure



The non-executive directors' committee (NedCo)

NedCo operates in line with the provisions of Schedule 1 to FSMA. During the year NedCo ensured that its statutory functions were being satisfactorily discharged by:

- reviewing reports on the efficient and economic use of our resources;
- receiving reports on the Audit Committee's (AuditCo) work in keeping under review the question of whether our internal financial controls secured the proper conduct of our financial affairs (via reports made to the Board);
- 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; and
- receiving reports from RemCo on its review of the priorities and focus of the executive directors' objectives and approving those objectives.

NedCo's composition is shown in Table 2. Further details on the statutory functions it discharges can be found on our website.

Report of the non-executive directors

The Board (which includes all non-executive directors) is our primary decision-making body. It also exercises a broad oversight of all our policy, strategic and operational activities. The extent of the Board's role, and the information provided to it, allows NedCo to rely largely on the Board's work while sharing other functions, including oversight of internal controls, with AuditCo. RemCo reports on its work to NedCo.

Efficiency and economy

During the year, NedCo reviewed whether we were using our resources in the most efficient and economic way. Data relating to the measurement of efficiency and economy forms part of the management information presented to the Board quarterly, and was reviewed specifically by NedCo. NedCo challenged the information provided to it and sought further explanations when appropriate.

Internal financial controls

During the year, AuditCo reviewed whether our internal financial controls secure the proper conduct of our financial affairs and provided feedback on this work to the Board. The full statement on internal controls, which includes information on financial controls, is on pages 114 – 115.

Remuneration of the executive directors

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

In addition to its statutory functions, NedCo met regularly to receive updates in relation to proposed changes to the regulatory architecture. It considered the implications for the operating structure and efficiency of the FSA, and the position of senior executives, including related retention and transition issues.

Remuneration report

This section of the remuneration report is not subject to audit.

Remuneration Committee (RemCo)

RemCo is a Committee of NedCo and is chaired by the chair of NedCo. The principal responsibilities are contained in its terms of reference, which can be found on our website.

During the year, RemCo met formally on three occasions, although a number of decisions were initially made by email and were later ratified.

Remuneration strategy

Our remuneration strategy is to provide a remuneration package that:

- helps to attract, retain and motivate staff;
- recognises our role and responsibilities as a public authority;
- is as competitive as possible against the appropriate market;
- encourages and supports a culture aligned to achieving our statutory objectives;
- is fair and transparent; and
- is capable of being applied consistently across the organisation.

Remuneration policy

To achieve the remuneration strategy, the remuneration policy aims to:

- set base salaries at, or around, the median of the relevant market competitive level;
- target reward at those whose performance is 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.

2011/12 Remuneration review

The total remuneration package, which is common to all FSA employees, comprises:

- basic pensionable salary;
- eligibility to be considered for a performance-related annual individual incentive award;
- other flexible benefits; and
- pension contribution (or money in lieu).

Information on the appointment of the chairman of the FSA and its executive directors can be

found in the Directors' Report and in Table 2. The information contained in the remuneration table has been audited by the external auditor. The executive directors have continuous contracts of employment that provide for less than twelve months' prior notice of termination by either party. The chairman is employed on a fixed-term contract which began on 20 September 2008 and ends on 19 September 2013.

RemCo is responsible for determining the remuneration of the executive directors. To help with this, RemCo received information on, and assessment of, their individual performance. Performance is measured against the achievement of our 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 are reviewed annually in line with the policy, although in the last two years in particular, increases were only awarded in exceptional cases. When making decisions on base salary, RemCo was mindful of the need for public sector organisations to continue to exercise restraint.

During the year, RemCo considered factors which would affect decisions including the fact that there had been no FSA-wide salary increase in the previous two years, the overall economic circumstances and the need to maintain stability within the organisation during the period through to legal cutover. As a result RemCo recommended to the Board that funds should be made available to support a wider pay review for the year 2012/13 than had been the case in 2010/11 or 2011/12.

Annual incentive award

The executive directors are eligible to be considered for a performance-related incentive award of up to a maximum of 35% of average base pensionable salary applying during the previous year.

Last year, we 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. In future years, performance years will be 1 April – 31 March.

For ease of reporting we show incentives as two separate amounts in the remuneration table on page 110. The first amount relates to the 12 months ended 31 December 2011 and is based on average salary for the period. The second amount relates to the three months ended 31 March 2012. If salary has not changed, this represents one quarter of the first payment (or one quarter of the average annualised salary for the three months if salary has changed).

The chairman is 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 individuals' performance.

Other benefits

A sum is available for each director, which may be spent against a range of benefits. The sum for the chairman and executive directors is included in 'other emoluments' in the remuneration table. The chairman and executive directors also have 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. Margaret Cole and Martin Wheatley are members of the defined contribution section. Adair Turner and Hector Sants are not members of the Plan and are entitled to receive a non-pensionable supplement. The sums paid to the chairman and each of the executive directors, in respect of each component, are shown in the remuneration table.

The Table below has been audited:

Remuneration table

	Board fee £	Salary £	Performance related bonus 12 months[3] £	Performance related bonus 3 months[3] £	Other emoluments and benefits £	Pension £	2012 Total £	2011 Total £
Chairman								
Adair Turner[1, 2]	-	426,000	-	-	22,274	52,200	500,474	500,276
Executive Directors								
Margaret Cole[4, 5]	-	417,938	90,000	23,000	29,618	55,383	615,939	263,686
Sally Dewar[6]	-	-	-	-	-	-	-	554,233
Jon Pain[7]	-	-	-	-	-	-	-	519,270
Hector Sants[2, 8, 9,18]	-	500,000	115,000	28,750	131,981	60,000	835,731	806,810
Martin Wheatley[5, 16]	-	250,833	29,000	21,500	60,180	38,144	399,657	-
Non-executive Directors[10]								
Amanda Davidson[11]	35,000	-	-	-	-	-	35,000	32,083
Sandra Dawson[11]	35,000	-	-	-	-	-	35,000	32,083
Carolyn Fairbairn[12, 19]	33,750	-	-	-	-	-	33,750	43,333
Peter Fisher[13]	-	-	-	-	-	-	-	-
Brian Flanagan	35,000	-	-	-	-	-	35,000	35,000
Karin Forseke[12, 17]	57,333	-	-	-	-	-	57,333	45,167
Mick McAteer	35,000	-	-	-	-	-	35,000	35,000
Brian Pomeroy[14]	55,000	-	-	-	-	-	55,000	51,667
Andrew Scott[12]	37,012	-	-	-	-	-	37,012	35,000
Hugh Stevenson[15]	-	-	-	-	-	-	-	14,833
James Strachan	35,000	-	-	-	-	-	35,000	35,000
Paul Tucker[13]	-	-	-	-	-	-	-	-
	358,095	1,594,771	234,000	73,250	244,053	205,727	2,709,896	3,003,443
Remuneration as executives							2,351,801	2,644,276
Fees for service as Directors							358,095	359,167
							2,709,896	3,003,443

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

1 In line with the terms of his contract, Adair Turner was awarded a salary increase to £435,000 with effect from April 2009, upon which his benefits are based. However at that time he decided to forego the increase and his salary remained at £416,000. With effect from 1 April 2010, he accepted an increase to £426,000.

2 Adair Turner and Hector Sants are not members of the FSA Pension Plan and received a non-pensionable supplement in lieu of pension contributions.

3 The performance-related bonuses for executive directors are the amounts approved by RemCo for 15 months for the period 1 January 2011 to 31 March 2012. This was a one-off transition and, in future, performance years will be 1 April to 31 March. The amounts for 2011/12 were paid via the April and May 2012 payrolls. Further information is set out on page 109. This follows a decision, with the approval of the Board, to align reward with the FSA's financial year. The comparison 2011 figures include bonuses for 12 months.

4 Margaret Cole was appointed as an executive director from 7 September 2010 and her remuneration disclosed for 2010/11 is pro rata from that date to 31 March 2011. She resigned as an executive director with effect from 31 March 2012 and was paid her contractual entitlement.

5 Margaret Cole and Martin Wheatley are members of the defined contribution section of the FSA Pension Plan.

6 Sally Dewar resigned as an executive director with effect from 9 January 2011 and was paid her contractual entitlement.

7 Jon Pain resigned as an executive director with effect from 31 January 2011 and was paid his contractual entitlement.

8 The total emoluments of the highest paid director during the year, Hector Sants, were £835,731 (2011: £806,810), which included £60,000 paid during the year as a non-pensionable supplement in lieu of pension contribution, and amounts for car and flexible benefits.

9 In respect of the 15 month performance period ended 31 March 2012, Hector Sants was awarded a total performance-related bonus of £143,750, which he declined to accept. At his request, that sum was paid by the FSA under the Workplace Giving UK scheme to The Art Room, which is a registered charity.

10 The fee for non-executive directors was set by an independent panel, established with the approval of HM Treasury (see below) at £35,000 per annum with effect from 1 April 2010. This remained unchanged in 2011/12.

11 Amanda Davidson and Sandra Dawson were appointed as non-executive directors from 1 May 2010.

12 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. Carolyn Fairbairn was appointed to chair the Risk Committee from 1 June 2010 until 31 December 2011. Andrew Scott was appointed to chair the Risk Committee from 19 January 2012. Karin Forseke chaired the Audit Committee throughout the year.

13 Peter Fisher and Paul Tucker both waived their Board fee in respect of the years concerned.

14 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 2011/12.

15 Hugh Stevenson's term as a director and chair of NedCo, chair of the FSA Pension Plan Trustee Ltd and chair of the Risk Committee ended with effect from 31 May 2010.

16 Martin Wheatley was appointed from 1 September 2011.

17 Karin Forseke has discharged the role of Chair of Nedco and Senior Independent Director since June 2010. She undertook additional work in relation to this and her appointment as Deputy Chair was formalised with effect from 1 June 2011. There was a modest adjustment to her fees to reflect the additional work to a total of £60,000 which included 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. As noted in last year's Annual Report, Karin Forseke received an overpayment of £167 during 2010/11. This was rectified during 2011/12.

18 Hector Sants has resigned as chief executive and as an executive director with effect from 30 June 2012. On leaving the FSA he will be paid his contractual entitlement.

19 Carolyn Fairbairn resigned as a director with effect from 31 December 2011.

Non-executive directors

In accordance with the Articles of Association, the assessment of fees for non-executive directors is carried out by an Independent Panel, the membership of which comprises the chair of the Practitioner Panel; a nominee of the chair of the Consumer Panel and an external moderator. In May 2011, the Panel reviewed the fees payable to the non-executive directors, deputy chair, chairs of Board committees and the chairman of the Pension Plan Trustee Board. In view of the economic conditions and the pay freeze imposed by the FSA for most of its staff, the Panel agreed that any proposals for increases would only be considered if there was an overwhelming business case. Enquiries carried out as part of the Panel's review did not suggest that there had been significant changes to workload or responsibilities in respect of any of the positions considered, and accordingly no increases were made to the fees payable for 2011/12. The fees payable are shown in the notes to the remuneration table.

Committees of the Board

Audit Committee (AuditCo)

AuditCo's purpose is 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 of the financial statements in the annual accounts and the statements that relate to financial controls and internal risk, and oversight of the external audit process. AuditCo does not review external risks to the FSA's statutory objectives, which is the responsibility of RiskCo, nor does it review individual firms.

AuditCo's terms of reference (which were reviewed during the year) and information on its membership can be found on our website. Information on AuditCo members' attendance at meetings can be found in Table 2.

A review of AuditCo's effectiveness and role, facilitated by external consultants, was undertaken but completed after the end of the 2011/12 financial year. This was undertaken alongside the review of the Board's effectiveness and included discussions with each of the committee members in relation to AuditCo's role and the way in which it carried out its duties.

AuditCo met on four occasions during the year. 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. The chief executive also attended two of the meetings. 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 and on its own without management present.

To discharge its functions AuditCo has carried out the following during 2011/12:

- 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 and approved the audit universe (i.e. the internal audit framework) and the audit plans for internal audit.

- Monitored and challenged the managers on their responsiveness to internal audit findings.

- Reviewed the quarterly reports from internal audit.

- Reviewed the independence and effectiveness of the external auditor. We aim to protect the external auditor's independence through our policy, which requires that fees for non-audit services are limited to the charge for performing the audit of our annual accounts. Information on fees paid to the auditor is given on page 134. Moreover, there are no relationships between the NAO or its staff and the FSA that affect the NAO's objectivity and independence.

- Considered the external auditor's audit strategy for the financial year.

- Oversaw a review of the FSA's Information Systems Strategy by external consultants.

- During the year the Audit Committee also agreed to commission a review of the adequacy and effectiveness of the Internal Audit function. In order 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, it was decided that the review should be carried out in the third quarter of 2012/13, when the FSA had been operating internal twin peaks for approximately six months. This work will be supported by an external consultant.

Risk Committee (RiskCo)

RiskCo's purpose is to assist the Board in reviewing external risks to its statutory objectives. It does not review internal risks, which are the responsibility of AuditCo, nor does it review individual firms.

RiskCo's terms of reference (which were reviewed during the year), and information on its membership, can be found on our website. Information on RiskCo members' attendance at meetings can be found in Table 2.

A review of RiskCo's effectiveness and role, facilitated by external consultants, was undertaken but completed after the end of the 2011/12 financial year. This was undertaken alongside the review of the Board's effectiveness and involved discussions with each of the committee members about RiskCo's role overseeing risks to our statutory objectives, and the way in which it carried out its duties.

The FSA executive's Risk Management and Reporting Framework records risks identified and reviewed by local business areas. The risks are further reviewed and appropriate mitigation strategies put in place by the FSA executive. RiskCo has 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 has used the FSA executive's Risk Management and Reporting Framework.

RiskCo has 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, arising within the environment that the FSA regulates, have 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 has also considered whether there are other risks that should be reviewed.

RiskCo reports to the Board on its consideration of the risk areas and provides feedback on the risk management framework as required.

Over the year, RiskCo has considered a number of forward-looking risk scenarios and a diverse range of risks and mitigation strategies, including:

- the likely growth in private sector debt levels resulting from increased pressure on disposable incomes and the role of housing and secured credit in an economic recovery;
- an analysis of earnings growth and key earnings drivers for the major UK banks over the last decade, to inform RiskCo's discussion around the mitigation of the risks arising to the FSA's objectives;
- considering the impact on firms, consumers, markets and financial stability of various possible outcomes to the Eurozone crisis;
- the controls already in place and further planned controls to mitigate the risk of a leak of sensitive information and the potential effect of any such leak;
- a review of the risks of the implementation of internal twin peaks; and
- a review of our rules relating to projections as they apply to products that are not financial instruments, considering the quality of firms' compliance and our attendant policy and thematic work.

Internal controls

The Board and NedCo (the latter under FSMA) are responsible for ensuring we have 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 our statutory objectives. The Board's policy on internal controls and risk management includes established processes and procedures for identifying, evaluating and managing significant risks.

Our internal control processes have been in place throughout the year and have been under review up until the date of approval of the Report and Accounts.

Key features of our internal control system include the following:

- Risk reporting that highlights the key internal and regulatory risks faced. This facilitates discussion on the best course of action to mitigate the key risks and helps senior managers make decisions on priorities and resource allocation. This is 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 contains all our activities, systems, projects and programmes. Each unit within the universe has been assessed appropriately to prioritise review by Internal Audit and these priorities are revised periodically. Factors considered include 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 above, a full review of the effectiveness of Internal Audit will be carried out later in the year.

- Clear reporting lines and delegated authorities, which are 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 is reviewed by AuditCo and reported to the Board on an annual basis.

- Clear segregation of the regulatory aspects of our supervisory operations and those of the internal treasury function. In addition a third party is used to decide, from a list of approved counterparties, where best to place our deposits for the optimum return. This enables us to adopt a robust 'Chinese Wall' arrangement in line with good market practice.

- Ensuring appropriate policies and procedures are contained within the staff handbook (which is available on our website).

- The performance management framework, which includes 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 is regularly communicated to all staff.

Regulatory Decisions Committee (RDC)

The RDC decides whether the FSA should give the statutory and other notices described as within its scope by the Handbook, any regulatory guide or legislation. Members of the RDC are appointed by the Board. The Board receives quarterly reports from the RDC Chairman, who also attends Board meetings twice a year to discuss significant matters in those reports. More details on the role and membership of the RDC can be found on our website.

Listing Authority Committees

The Board has two listing committees to advise the Board and review elements of our function as the competent authority for listing in the UK. The Listing Authority Advisory Committee (LAAC), the membership of which comprises external practitioners, met three times during the year, with a number of smaller sub-group and other informal meetings taking place during the year to consider particular issues. The chairman provided reports to the Board on relevant issues.

The Listing Authority Review Committee, whose role is as a technical appeal committee, has not been called during the year. More details on membership of the committees can be found on our website.

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 year ended 31 March 2012 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 was also engaged by the Directors to audit the information in the directors' remuneration report that is described as having been audited.

Respective responsibilities of directors and auditors

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 Practice 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 2012 and of its surplus for the period then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the 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 year 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 am required to 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 the information and explanations I require for my audit.

Bryan Ingleby (Senior Statutory Auditor) 24 May 2012

for and on behalf of the
Comptroller and Auditor General (Statutory Auditor)

157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Financial statements for the year ended 31 March 2012

Statement of comprehensive income for the year ended 31 March 2012

	Notes	Total 2012 £m	Continuing operations 2011 £m	Operations transferred[1] 2011 £m	Total 2011 £m
Administrative costs		(526.1)	(475.9)	(0.7)	(476.6)
Interest on bank deposits		1.8	1.6	-	1.6
Other net finance costs	15	(4.2)	(3.0)	-	(3.0)
Profit on disposal	5	12.8	-	-	-
Other income	7	45.7	44.1	-	44.1
Net costs for year		**(470.0)**	**(433.2)**	**(0.7)**	**(433.9)**
Fee income		505.9	462.9	1.3	464.2
Surplus before taxation	5	**35.9**	**29.7**	**0.6**	**30.3**
Taxation	8	(0.4)	(0.4)	-	(0.4)
Surplus after taxation		**35.5**	**29.3**	**0.6**	**29.9**
Net actuarial losses for the year in respect of the defined benefit pension scheme	15	(7.9)	(13.3)	-	(13.3)
Total comprehensive income for the year		**27.6**	**16.0**	**0.6**	**16.6**

1 Operations transferred to Money Advice Service in the year ending 31 March 2011.

Statement of changes in equity for the year ended 31 March 2012

	£m
At 1 April 2010	**(110.3)**
Total comprehensive income for the year	16.6
At 31 March 2011	**(93.7)**
Total comprehensive income for the year	27.6
At 31 March 2012	**(66.1)**

Statement of financial position as at 31 March 2012

Company Number: 1920623

	Notes	2012 £m	Restated[1] 2011 £m	Restated[1] 2010 £m
Non current assets				
Intangible assets	9	96.1	77.2	55.3
Property, plant and equipment	10	60.5	77.3	62.6
		156.6	**154.5**	**117.9**
Current assets				
Trade and other receivables	11	30.9	15.5	13.8
Cash and cash equivalents	11	72.0	100.1	31.0
		102.9	**115.6**	**44.8**
Total assets		**259.5**	**270.1**	**162.7**
Current liabilities				
Trade and other payables	12	(200.1)	(233.1)	(144.8)
Current tax liabilities	12	(0.2)	(0.2)	-
Provisions	12	-	-	(0.8)
Borrowings	12/13	(1.2)	-	-
		(201.5)	**(233.3)**	**(145.6)**
Total assets less current liabilities		**58.0**	**36.8**	**17.1**
Non current liabilities				
Trade and other payables	12	(17.0)	(16.0)	(14.6)
Long term provisions	14	-	-	(0.1)
Net asset excluding retirement benefit obligation		**41.0**	**20.8**	**2.4**
Retirement benefit obligation	15	(107.1)	(114.5)	(112.7)
Net liabilities, including retirement benefit obligation		**(66.1)**	**(93.7)**	**(110.3)**
Accumulated deficit		**(66.1)**	**(93.7)**	**(110.3)**

1 Restated – 2011 and 2010 figures have been restated to recognise penalties on an accruals basis rather than on a cash basis.

The financial statements were approved and authorised for issue by the Board on 24 May 2012, and were signed on its behalf by:

Adair Turner .... Chairman

Hector Sants .... Chief Executive Officer

Statement of cash flows for the year ended 31 March 2012

	Notes	2012 £m	2011 £m
Net cash generated from operations	**20**	**(2.3)**	**132.6**
Corporation tax paid		(0.4)	(0.2)
Net cash from operating activities		**(2.7)**	**132.4**
Investing activities			
Interest received on bank deposits		1.8	1.6
Expenditure on software development	9	(28.1)	(36.3)
Purchases of property, plant and equipment	10	(12.9)	(28.6)
Sale of asset		15.0	-
Net cash used in investing activities		**(24.2)**	**(63.3)**
Returns on investment and servicing of finance			
Proceeds from borrowings		(1.2)	-
Net (decrease)/increase in cash and cash equivalents		**(28.1)**	**69.1**
Cash and cash equivalents at the start of the year		100.1	31.0
Cash and cash equivalents at the end of the year		**72.0**	**100.1**

Notes to the financial statements – 31 March 2012

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.

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.

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

In line with last year, we continue to disclose three comparative periods for the statement of financial position and the statement of changes in equity.

b. Changes in accounting policy

i. New and amended standards adopted by the company:

There were no IFRS or International Financial Reporting Interpretations Committee (IFRIC) interpretations that are effective for the first time in the financial year beginning on or after 1 April 2011 that have a material impact on the company.

ii. New standards, amendments and interpretations issued but not effective for the financial year 1 April 2011 and not early adopted:

Amendment to IAS 19 'Employee Benefits'. These amendments eliminate the corridor approach and calculate finance costs on a net funding basis. The main change will be that the expected rate of return on assets must be set equal to the discount rate, which will increase the pension cost going forward. The effective date is 1 January 2012.

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

iii. Other changes:

Change in accounting for financial penalties: The FSA imposes penalties on the industry where an entity or individual breaches the FSA's rules or the provisions of FSMA. From an accounting perspective, imposing a penalty creates a current asset, representing the amount receivable from the individual or entity and an equal and opposite current liability, recognising the fact that penalties collected by the FSA are returned to the industry in the form of lower levies the year following the penalties being levied.

In prior years, the FSA did not recognise any uncollected penalties in its statement of financial position. In the current and future years, the FSA will recognise all penalties levied, whether collected or not. The FSA will then assess the recoverability of those penalties and make appropriate provision against those receivables to recognise any impairment. The directors believe accounting for penalties on an accruals basis leads to a more accurate representation of the FSA's statement of financial position. Under International Accounting Standard 8 Accounting Policies, Changes in Accounting Estimates and Errors, the FSA has retrospectively applied this change in accounting policy.

The adoption of this change in policy has:

- no impact on the statement of comprehensive income;
- resulted in the creation of a bad debt provision for penalties receivable, the details and movements of that provision are set out in Note 11; and
- resulted in an equal and opposite net increase in both Trade and other receivables and Trade and other payables of £1.4m in 2012, £1.1m in 2011 and £0.2m in 2010.

Change in accounting for Special Project Fees (SPFs): The FSA levies SPFs to recover the costs of exceptional supervisory or regulatory work for firms restructuring their business. Exceptional is where costs incurred by the FSA exceed £50,000 for each piece of work.

In the prior year, the FSA recognised expenses incurred for SPFs but did not recognise any income recovered against these costs. In the current and future years, the FSA will recognise all

costs incurred in the year for SPFs and will also recognise the accrued income for the recovery/ recharge of these costs in the same period as they will be levied to the specific firm.

The directors believe accounting for SPFs on this basis is a more accurate representation of the FSA's statement of financial performance, reflecting the accruals principle outlined in International Accounting Standard 1. No adjustment has been made to the prior year as the amounts are immaterial.

The adoption of this change in policy has:

- resulted in income and expenses being recognised in the same period in the statement of comprehensive income totalling £0.2m; and
- resulted in any costs that have been incurred and recharged to firms but not received as at 31 March 2012 being reflected as a receivable in the statement of financial position.

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 those costs. It is considered that this format best represents the nature of the activities of the FSA, which involves 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 in respect of the financial year.

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

Any surplus revenue from the Transaction Reporting System (TRS), Scope Change and 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
Computer equipment (excluding software)	Up to five years
Furniture and equipment	Ten years
Motor vehicles	Four years

The asset's 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.

If events or changes in circumstances indicate the carrying value may not be recoverable then the carrying values of property, plant and equipment are reviewed for impairment.

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 also 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.

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 recognised as an expense immediately.

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 recognised as income immediately.

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

Under FSMA, the FSA has the power to levy financial penalties and it is required to apply those penalties for the 'benefit of its fee-payers', which means that the FSA has no entitlement to recognise these amounts as income. Accordingly, all penalties levied are included as an asset in trade receivables (where not collected) and in current liabilities: trade and other payables. The FSA is required to apply penalties received in each financial year to reduce the amount invoiced to fee-payers in the following financial year.

The financial penalties levied are assessed for recoverability and a provision raised where the recoverability of such penalties has been impaired (see l. Provisions below).

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 the asset is impaired. The allowance recognised is measured as the difference between the 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:

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 terms of collecting fees with bad debt experience averaging at less than 0.3% of fees receivable over the last 3 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, those financial penalties levied under FSMA and collected during the financial year, which will be returned to fee payers the following financial year.

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 lease term.

l. 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 tax expense represents the sum of tax currently payable. The FSA is only liable to pay corporation tax on investment income.

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 in respect 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 judgement that has the most significant effect on the amounts recognised in the financial statements (apart from those involving estimates, which are dealt with below):

- Intangible assets – under IAS 38, internal software development costs of £28.1m (2011: £36.3m) 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, that 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 15) relating to the discount rate, the expected return on the plan's assets, 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% per annum if lower, although some of the pension rights transferred in from the FSA's predecessor organisations receive different level of pension increases.

The 31 March 2012 calculations make no allowance for any potential implications of the change in inflation index used for legislative pension indexation from the RPI to the Consumer Prices Index (CPI). This is consistent with the disclosures as at 31 March 2011.

4. Business and geographical analysis

Business units

The FSA is structured to align with its key statutory objectives: financial stability; market confidence; consumer protection and a reduction of financial crime.

Prudential business unit (PBU) and Conduct business unit (CBU)

On 4 April 2011 the FSA realigned its internal management structure to the PBU and CBU to effect a smooth transition to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). We have restated the 2010/11 comparatives according to the new structure.

Prudential business unit

The PBU is responsible for:

- the prudential supervision of a large spectrum of firms (including UK banks and building societies, insurance firms, and investment and overseas banks) at a level appropriate to the impact they have on the UK economy (in the event of their failure);

- the specialist supervision of 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 all 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 negotiation of policy input into key prudential EU Directives and specific international agreements.

Conduct business unit

The CBU 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 which 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 business unit (OBU)

The OBU works in partnership with the rest of the business as one team, to deliver quality and value for money. This includes the set-up and maintenance of processes and systems required to deliver the FSA's objectives. The business unit focuses on ensuring we have the right people to deliver our 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 business unit 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

The aim of this division is to conduct forensic investigations into suspected misconduct and compliance failures, and to help the FSA deliver its statutory objective to reduce financial crime.

Other central services

These represent all divisions reporting directly to the Chairman and Chief Executive. The aim of these division are to ensure that the Chairman and the Board are able to fulfil their stewardship and corporate governance responsibilities; and to provide support to the CBU and PBU in carrying out end-to-end intensive supervision and delivering our credible deterrence strategy.

Segmental information about the FSA's operations is presented below:

Year ended 31 March 2012	Prudential £m	Conduct £m	Operations £m	Enforcement & Financial Crime £m	Other central services £m	Total 2012 £m
Income						
Fee income	-	-	505.9	-	-	**505.9**
Other income	23.8	10.1	8.6	1.5	1.7	**45.7**
Administrative costs	(158.9)	(136.6)	(85.4)	(71.0)	(74.2)	**(526.1)**
Segmental surplus/ (deficit)	**(135.1)**	**(126.5)**	**429.1**	**(69.5)**	**(72.5)**	**25.5**
Interest on bank deposits	-	-	1.8	-	-	**1.8**
Other net finance costs	-	-	(4.2)	-	-	**(4.2)**
Profit on disposal	-	12.8	-	-	-	**12.8**
Surplus/(deficit) before taxation	**(135.1)**	**(113.7)**	**426.7**	**(69.5)**	**(72.5)**	**35.9**
Taxation	-	-	(0.4)	-	-	**(0.4)**
Surplus/(deficit) after taxation	**(135.1)**	**(113.7)**	**426.3**	**(69.5)**	**(72.5)**	**35.5**

Year ended 31 March 2011

	Prudential £m	Conduct £m	Operations £m	Enforcement & Financial Crime £m	Other central services £m	Continuing operations £m	Operations transferred[1] £m	Total 2011 £m
Income								
Fee income	-	-	462.9	-	-	462.9	1.3	**464.2**
Other income	21.9	6.7	12.6	1.3	1.6	44.1	-	**44.1**
Administrative costs	(161.6)	(131.7)	(56.8)	(67.0)	(58.8)	(475.9)	(0.7)	**(476.6)**
Segmental surplus/ (deficit)	**(139.7)**	**(125.0)**	**418.7**	**(65.7)**	**(57.2)**	**31.1**	**0.6**	**31.7**
Interest on bank deposits	-	-	1.6	-	-	**1.6**	-	**1.6**
Other net finance costs income	-	-	(3.0)	-	-	(3.0)	-	**(3.0)**
Surplus/ (deficit) before taxation	**(139.7)**	**(125.0)**	**417.3**	**(65.7)**	**(57.2)**	**29.7**	**0.6**	**30.3**
Taxation	-	-	(0.4)	-	-	(0.4)	-	**(0.4)**
Surplus/ (deficit) after taxation	**(139.7)**	**(125.0)**	**416.9**	**(65.7)**	**(57.2)**	**29.3**	**0.6**	**29.9**

1 Operations transferred to Money Advice Service in the year ending 31 March 2011.

Statement of financial position analysis

Whereas the FSA allocates its costs to business segments, as set out above, it does not allocate assets and liabilities to those segments. This is for two reasons. Firstly our working capital cannot be allocated to business segments. Secondly, as we are not a profit-making organisation, we do not consider return on capital measures.

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 year has been arrived at after charging the following:

	Note	2012 £m	Restated[1] 2011 £m
Depreciation of property, plant and equipment	10	16.4	13.8
Amortisation of intangible assets	9	15.9	10.7
Impairment loss	9/10	(5.8)	(3.7)
Employment costs	6	301.9	278.1
Profit on disposal		12.8	-
Operating lease rentals		15.2	15.2
Regulatory reform costs		11.4	-

1 Restated – Employment costs restated to include non pensionable allowance totalling £1.3m.

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 TRS to the London Stock Exchange. The net profit on disposal was £12.8m.

Auditors

The National Audit Office were appointed as auditor on the 24 August 2010.

The auditor's remuneration for audit services is set out below:

Total fees	12 months to 31 March 2012 £'000	Restated[1] 12 months to 31 March 2011 £'000
Fees payable to the National Audit Office for the audit of the FSA's annual accounts	70	70

1 Restated – The 2011 fees were shown inclusive of VAT (£84,000), they have now been restated excluding VAT in line with the Companies Act 2006.

6. Employee information

The average number of full-time equivalent employees (including executive directors) during the year was 3,439 (2011: 3,291). The average number of permanent full-time equivalent employees in each business unit during the year was as follows:

	2012	2011
Prudential	1,044	880
Conduct	995	1,115
Operations	563	542
Enforcement and Financial Crime	409	319
Other central services	428	435
Total	**3,439**	**3,291**

As at 31 March 2012, the FSA had 3,502 (2011: 3,337) permanent full-time equivalent employees on its payroll.

Employment costs (including executive directors) comprise:	**Notes**	**2012 £m**	**Restated[1] 2011 £m**
Gross salaries and taxable benefits		244.2	226.0
Employer's national insurance costs		25.6	22.7
Defined contribution scheme		32.0	29.3
Other employer's pension costs included in administrative costs		0.1	0.1
	5	301.9	278.1
Net pension finance costs (included in other finance costs)	15	4.2	3.0
Actuarial losses in respect of the defined benefit pension scheme	15	7.9	13.3
Total employment costs		**314.0**	**294.4**

1 Restated – Employment costs restated to include non pensionable allowance totalling £1.3m.

7. Other income

Other income comprises:

Continuing operations:	**2012 £m**	**2011 £m**
Application fees and other regulatory income	10.7	13.1
Transaction reporting services	3.7	7.0
Publications and training services	1.4	1.2
Benchmarking income	-	0.1
Solvency II income	23.0	16.0
Professional fees recovered	0.7	0.8
Other sundry income	6.2	5.9
Total other income	**45.7**	**44.1**

8. Taxation

The tax charge on ordinary activities is:

	2012 £m	2011 £m
Corporation tax charge for the year	0.4	0.4

Under an agreement with Her Majesty's Revenue and Customs (HMRC), the FSA is not subject to corporation tax on income arising from its regulatory activities. Consequently, the tax charge arises solely on net investment income.

The disposal of TRS did not crystallise a corporation tax liability as it was agreed with HMRC that roll-over relief was available.

The total charge for the year can be reconciled to the accounting surplus as follows:

	2012 £m	2011 £m
Surplus before tax	35.9	30.3
Tax at 26% (2011: 28%) thereon	9.3	8.5
Effects of:		
Adjustment for activities not subject to corporation tax	(8.9)	(8.1)
Current tax charge for the year	0.4	0.4
Effective tax rate for the year	1.2%	1.3%

9. Intangible assets

	Internally generated software £m	Other software £m	Total £m
Cost			
At 1 April 2010	**90.5**	**-**	**90.5**
Additions – internally generated	36.3	-	36.3
Impairments	(3.7)	-	(3.7)
At 31 March 2011	**123.1**	**-**	**123.1**
Additions – internally generated	28.1	-	28.1
Transfers	-	23.5	23.5
Disposal	(0.8)	-	(0.8)
Impairments	(12.8)	-	(12.8)
At 31 March 2012	**137.6**	**23.5**	**161.1**
Accumulated depreciation			
At 1 April 2010	**35.2**	**-**	**35.2**
Charge for year	10.7	-	10.7
At 31 March 2011	**45.9**	**-**	**45.9**
Transfers	-	10.8	10.8
Charge for year	15.9	-	15.9
Disposal	(0.2)	-	(0.2)
Impairments	(7.4)	-	(7.4)
At 31 March 2012	**54.2**	**10.8**	**65.0**
Net book value			
At 31 March 2012	**83.4**	**12.7**	**96.1**
At 31 March 2011	**77.2**	**-**	**77.2**
At 31 March 2010	**55.3**	**-**	**55.3**

Per note 10 – Purchased computer software that is not an integral part of the related hardware has been restated as an intangible asset as other software, the net book value of this is £12.7m.

At 31 March 2012, work in progress with a net book value of £29.7m (2011: £45.0m, 2010: £28.8m) was included in internally generated software.

10. Property, plant and equipment

	Leasehold improvements £m	Restated[1] Computer equipment £m	Furniture and equipment £m	Total £m
Cost				
At 1 April 2010	**35.5**	**86.3**	**18.9**	**140.7**
Transfer	-	3.4	(3.4)	-
Additions	4.2	21.4	3.0	28.6
Disposals	(1.7)	(2.3)	(2.3)	(6.3)
At 31 March 2011	**38.0**	**108.8**	**16.2**	**163.0**
Transfer	-	(23.5)	-	(23.5)
Additions	0.5	12.1	0.3	12.9
Impairments	-	(0.9)	-	(0.9)
Disposals	-	(3.0)	-	(3.0)
At 31 March 2012	**38.5**	**93.5**	**16.5**	**148.5**
Accumulated depreciation				
At 1 April 2010	**18.2**	**53.4**	**6.5**	**78.1**
Transfer	-	0.7	(0.7)	-
Charge for year	2.6	9.8	1.4	13.8
Disposals	(1.7)	(2.2)	(2.3)	(6.2)
At 31 March 2011	**19.1**	**61.7**	**4.9**	**85.7**
Transfer	-	(10.8)	-	(10.8)
Charge for year	2.7	12.4	1.3	16.4
Impairment	-	(0.5)	-	(0.5)
Disposals	-	(2.8)	-	(2.8)
At 31 March 2012	**21.8**	**60.0**	**6.2**	**88.0**
Carrying amount				
At 31 March 2012	**16.7**	**33.5**	**10.3**	**60.5**
At 31 March 2011	**18.9**	**47.1**	**11.3**	**77.3**
At 31 March 2010	**17.3**	**32.9**	**12.4**	**62.6**

1 Restated – Purchased computer software that is not an integral part of the related hardware has been restated as an intangible asset, the net book value of this is £12.7m.

At 31 March 2012, expenditure classified as work in progress with a net book value of £8.3m (2011: £30.9m) was included in property, plant and equipment.

The FSA has reviewed the residual values used for the purposes of depreciation calculations, with appropriate provisions made. The review did not identify any requirement for adjustment to the residual values used in the current or prior periods.

11. Current assets

	2012 £m	Restated[1] 2011 £m	Restated[1] 2010 £m
Fees and financial penalties receivables	2.9	2.5	3.5
Other debtors	10.6	1.1	1.1
Prepayments and accrued income	17.4	11.9	9.2
Trade and other receivables	30.9	15.5	13.8
Cash deposits	72.0	97.1	26.9
Cash	-	3.0	4.1
Cash and cash equivalents	72.0	100.1	31.0
Total current assets	**102.9**	**115.6**	**44.8**

1 Restated – The accounting treatment of financial penalties was changed during the year to recognise penalties on an accrued basis rather than a cash received basis.

The average credit period taken is 34 days (2011: 37 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 £0.5m (2011: £1.2m) 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.

	2012 £m	2011 £m	2010 £m
1 April	6.6	1.6	-
Increase in provision for financial penalties	8.0	5.0	1.6
At 31 March	**14.6**	**6.6**	**1.6**

The directors consider that the carrying amount of trade and other receivables approximates their fair value.

In addition, some of the unimpaired fee receivables are past due as at 31 March 2012. The age of fee receivables past due, but not impaired is as follows:

	2012 £m	2011 £m	2010 £m
Not more than three months	0.2	0.4	0.8
More than three months but not more than six months	-	0.1	-
More than one year	0.1	0.2	0.1
Total	**0.3**	**0.7**	**0.9**

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 balances which are over one year old consist of two debts. Both relate to expected creditor dividend payments arising from the realisation of assets of liquidated debtor firms.

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 their fair value.

12. Liabilities

Current liabilities

	2012 £m	Restated[1] 2011 £m	Restated[1] 2010 £m
Trade creditors and accruals	84.6	98.6	83.9
Other taxation and social security	8.5	7.0	6.7
Financial penalties to be applied against future fees receivable	71.7	93.6	33.7
Fees received in advance	35.3	33.9	20.5
Trade and other payables	200.1	233.1	144.8
Current tax liabilities	0.2	0.2	-
Provisions	-	-	0.8
Borrowings	1.2	-	-
Total current liabilities	**201.5**	**233.3**	**145.6**

1 Restated – The accounting treatment of financial penalties was changed during the year to recognise penalties on an accrued basis rather than a cash received basis.

Trade creditors and accruals principally comprise amounts outstanding for trade purchases and ongoing costs. The average credit period taken for trade payables is 24 days (2011: 30 days). The directors consider the carrying amount of trade payables approximates their fair value.

In accordance with IFRS 7 the following items are classified as financial liabilities measured at amortised cost:

- trade creditors and accruals;
- financial penalties; and
- provisions.

As at 31 March 2012, the FSA's liabilities have contractual maturities which are summarised below:

	Current					
	Within 6 months			6 to 12 months		
	2012 £m	Restated[1] 2011 £m	Restated[1] 2010 £m	2012 £m	Restated[1] 2011 £m	Restated[1] 2010 £m
Trade creditors and accruals	84.3	90.4	74.3	0.3	8.2	9.6
Fees in advance	35.3	33.9	20.5	-	-	-
All other liabilities	81.6	100.8	41.2	-	-	-
Total	**201.2**	**225.1**	**136.0**	**0.3**	**8.2**	**9.6**

1 Restated - The accounting treatment of financial penalties was changed during the year to recognise penalties on an accrued basis rather than a cash received basis.

Non-current liabilities

Non-current liabilities measured at amortised cost

	2012 £m	2011 £m	2010 £m
Lease accrual	15.9	16.0	14.7
Solvency II	1.1	-	-
Total non-current liabilities	**17.0**	**16.0**	**14.7**

The lease accrual of £15.9m (2011: £16.0m), 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 17.

As at 31 March 2012, the FSA's liabilities have contractual maturities which are summarised below:

	Non-current					
	1 to 5 years			Later than 5 years		
	2012 £m	2011 £m	2010 £m	2012 £m	2011 £m	2010 £m
Trade creditors and accruals	9.9	7.5	3.5	6.4	8.5	11.1
Fees in advance	0.7	-	-	-	-	-
Total	**10.6**	**7.5**	**3.5**	**6.4**	**8.5**	**11.1**

13. Borrowings

At 31 March 2012, the FSA had minimal borrowings and had available credit facilities of £151m (2011: £151m) made up of two £75m undrawn committed borrowing facilities in respect of which all conditions precedent had been met, and an undrawn £1m overdraft facility.

The revolving credit facility for £75m with Lloyds Banking Group expires on 30 March 2013, with any drawings made on the day prior to expiry being repayable in full by 30 June 2013.

The revolving credit facility with HSBC Banking Group expires on 27 May 2012 and any drawings are repayable in full by 27 May 2012. The FSA is in the process of extending this facility for a further twelve months to take it through the regulatory transition period. The £1m overdraft facility with Lloyds is due to expire on 30 June 2012 and the FSA is also in the process of renewing this facility. The directors have every expectation that these facilities will be renewed on appropriate commercial terms.

All borrowing are unsecured.

14. Long-term provisions

	2012	2011	2010
	£m	£m	£m
At 31 March	**-**	**-**	**0.1**

15. 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 with respect to members of the *Final Salary Section* of the Plan. All active members of the *Final Salary Section* became deferred members as 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 2011, 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:

At 31 March	**2012**	**2011**	**2010**
Corporate bond discount rate	5.25%	5.60%	5.70%
Expected return on plan assets	5.25%	6.05%	6.60%
Retail price inflation (RPI)	3.30%	3.50%	3.50%
Future pension increases	3.05%	3.35%	3.35%

The change in discount rate has resulted in an increase of £31.7m in the present value of the pension fund obligation and the deficit of the Plan.

The change in the RPI assumption (including the impact on expected future pension increases) has resulted in a decrease of £22.3m in the present value of the pension fund obligation and the deficit of the Plan.

A change was also made to the assumption regarding the take-up of cash commutation at retirement (also incorporating changes made by the Trustees to the terms available on commutation). This change has resulted in an increase of £4.1m in the present value of the pension funded 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 2012 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:

	2012 Years	**2011 Years**	**2010 Years**
Retiring today aged 60			
Males	28.5	28.5	28.6
Females	29.7	29.6	31.8
Retiring in 15 years aged 60			
Males	29.9	29.8	29.6
Females	31.2	31.1	32.6

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 2012**		**Increase/(decrease) in pension cost in year to 31 March 2012**	
		£m	**%**	**£m**	**%**
Present Value of funded obligation	Assumptions as above – no change	480.7	-	4.9	-
Discount rate	10 bps increase to 5.35%	(8.8)	(1.8%)	0.0	0.1%
Discount rate	10 bps decrease to 5.15%	9.0	1.9%	(0.0)	(0.2%)
Longevity	1 additional year of life at age 60	6.6	1.4%	0.3	6.9%
Inflation	10 bps increase to 3.4%	6.2	1.3%	0.3	6.5%

The amounts recognised in the statements of financial position are:

	2012 £m	**2011 £m**	**2010 £m**
Fair value of Plan assets	375.9	339.7	316.6
Less: Present value of funded obligations	(480.7)	(451.9)	(427.2)
Deficit in the scheme	**(104.8)**	**(112.2)**	**(110.6)**
Unfunded pension liabilities	(2.3)	(2.3)	(2.1)
Net liability recognised in the statement of financial position	**(107.1)**	**(114.5)**	**(112.7)**

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 2012 the liability is £2.3m (2011: £2.3m, 2010: £2.1m) 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:

	2012 £m	**2011 £m**	**2010 £m**
Expected return on plan assets	20.8	21.1	14.2
Interest cost on scheme liabilities	(25.0)	(24.1)	(20.6)
Other net finance costs	**(4.2)**	**(3.0)**	**(6.4)**

Actuarial losses of £7.9m (2011: £13.3m, 2010: £38.3m) 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:

	2012 £m	2011 £m	2010 £m
Opening obligation	(451.9)	(427.2)	(310.0)
Current service cost	-	-	(6.6)
Past service cost	-	-	(1.1)
Benefits paid	9.7	9.9	7.9
Interest cost on scheme liabilities	(25.0)	(24.1)	(20.6)
Actuarial (losses)	(13.5)	(10.5)	(106.7)
Curtailments	-	-	9.9
Closing obligation	**(480.7)**	**(451.9)**	**(427.2)**

Changes in the fair value of the Plan assets are as follows:

	2012 £m	2011 £m	2010 £m
Opening fair value of plan assets	339.7	316.6	222.8
Expected return on plan assets	20.8	21.1	14.2
Actuarial gains/(losses)	5.6	(2.8)	68.4
Contributions by the employer	19.5	14.7	19.1
Benefits paid	(9.7)	(9.9)	(7.9)
Closing fair value of Plan assets	**375.9**	**339.7**	**316.6**

The fair value of the Plan assets and the expected rates of return are:

	Expected rate of return	Fair value £m	Restated[1] Expected rate of return	Fair value £m
	At 31 March 2011		At 31 March 2011	
Equity securities	6.2%	171.1	7.1%	169.5
Debt securities	4.2%	171.8	4.9%	140.4
Real estate	5.1%	29.2	6.0%	27.2
Cash	0.5%	3.8	0.5%	2.6
Closing fair value of Plan assets	**5.3%**	**375.9**	**6.1%**	**339.7**

1 Restated – The 2011 figures for the expected return on debt securities has been amended to reflect a weighting of the assumptions for corporate bonds and gilts (previously this showed the rate of return for corporate bonds). Please note this does not impact on the 2011 year end figures.

Cumulative actuarial gains and losses recognised in the statement of earnings:

	2012 £m	2011 £m	2010 £m
1 April	(105.2)	(91.9)	(53.6)
Net actuarial losses recognised in the year	(7.9)	(13.3)	(38.3)
At 31 March	**(113.1)**	**(105.2)**	**(91.9)**

There are no deferred tax implications of the above deficit as corporation tax is only payable on interest receivable by the company.

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 are as follows:

	2012	2011	2010	2009	2008
Defined benefit obligation (£'m)	(480.7)	(451.9)	(427.2)	(310.0)	(363.0)
Fair value of Plan assets (£'m)	375.9	339.7	316.6	222.8	273.3
Net deficit (£'m)	**(104.8)**	**(112.2)**	**(110.6)**	**(87.2)**	**(89.7)**
Experience adjustments on Plan assets:					
Amount (£m)	5.5	(2.8)	68.4	(78.1)	(40.9)
Percentage of Plan assets	1.5%	0.8%	21.6%	35.1%	15.0%
Experience gains and losses on Plan liabilities:					
Amount (£m)	nil	(13.5)	(0.6)	0.6	(0.3)
Percentage of the present value of Plan liabilities	0.0%	(3.0%)	(0.1%)	0.2%	0.1%

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 in respect of the Financial Ombudsman Scheme) to be paid over the 10 years from 1 April 2011 with the aim of removing the Plan deficit (2011: £14.0m).

Money Purchase Section (Defined Contribution)

The total expense recognised in the statement of comprehensive income of £32.0m (2011: £29.3m) represents contributions payable to the plan by the FSA at rates specified in the rules of the Plan.

16. Capital commitments

The FSA had entered into contracts at 31 March 2012 for future capital expenditure totalling £6.8m (2011: £5.9m), which is not provided for in the accounts.

17. 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:

	2012 £m	2011 £m
Within one year	20.0	14.8
In the second to fifth years inclusive	74.5	69.0
After five years	38.0	48.3
Total	**132.5**	**132.1**

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.

18. 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. Of this group 26 (2011: 28) 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.

	2012[2] £m	Restated[1] 2011 £m
Short-term benefits	7.9	9.0
Post-employment benefits	0.8	0.9
Termination benefits	0.6	0.3
Total	**9.3**	**10.3**

1 Restated – The prior period figures have been restated to remove the Employer's NI.

2 The performance related bonus for 2012 are the amounts approved by the Board for 15 months covering 1 January 2011 to 31 March 2012. This is a one-off transition and in future the performance related bonus will be for 12 months in line with the financial year.

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 statues to establish the financial services regulatory organisations set out below under a) to d), it is the individual organisations themselves that are required to perform the functions.

Separately, whilst 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 of this benefit 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 £0.3m (2011: £0.3m). The net amount of fees collected that remained to be paid over by the FSA to FSCS at 31 March 2012 was £nil (2011: £1.6m) and the amount due to the FSA from the FSCS was £0.1m.

The FSA acts as guarantor to the lease agreement for FSCS's premises. This lease is due to end in June 2018.

b) The Financial Ombudsman Service Limited (the ombudsman service)

The FSA is the principal employer in the FSA Pension Scheme described in note 15. 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 in respect of its fees for 2006/07 onwards. The charge for that service was £0.1m (2011: £0.1m). As at 31 March 2012, £0.1m of fees (including on-account fees) relating to 2012/13 invoices had been collected but not paid to the ombudsman service. (2011/12: £1.3m).

The FSA acts as guarantor to the lease agreement for part of the ombudsman service premises. The lease is due to end in November 2014.

c) Money Advice Service (MAS)

During the year, the FSA provided a number of services to the MAS which included the provision of revenue, payroll, IS and facilities services. The FSA ceased to provide most of these services from November 2011 following the relocation of the MAS to its own premises. The FSA has, however, continued to provide a revenue service to the MAS. The charge for all services provided to the MAS in the financial year ended 31 March 2012 was £2.3m.

As at 31 March 2012 there is an amount owed to the FSA from the MAS of £9.3m; being the net fees collected that remained to be paid over to the MAS by the FSA of £0.1m and an amount advanced to the MAS from the FSA of £9.4m.

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, however, 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 2011/12, the FSA transferred £0.6m (2011: £0.5m) 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 2012 the balance owing to the FSA from the OCC was £nil (2011: £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 actually 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 account 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.

19. Contingent liabilities

The proposals for a new regulatory regime and the creation of two new regulatory authorities, will result in some staff transferring from the FSA to the PRA at 'legal cutover', along with the associated assets and liabilities required for the PRA to carry out prudential supervision. The transfer of staff will necessarily result in a re-organisation of the FSA's property portfolio which will potentially have implications for tangible and intangible assets held on the FSA's balance sheet and their values.

Any financial obligations arising from the re-organisation of the regulatory regime are contingent on the proposed legislation becoming an Act of Parliament and consequently the 2011/12 financial statements do not incorporate provision for any such obligations.

The following table summarises the FSA's contingent liabilities:

	2012 £m
Dilapidations	4.6
Leasehold improvements	3.2
Furniture, fixtures and fittings – cabling	0.6
Contingent Liabilities	8.4

Dilapidations

The FSA has operating leases for its office properties which include contractual obligations for dilapidations at the point of exit of these leases. At the balance sheet date, the FSA has not recognised any liability for property dilapidations as this remains contingent on deciding whether it will exit its office leases.

The £4.6m contingent liability includes £1.7m for four floors leased at 1 Canada Square. Should the regulatory reform legislative process complete, the Bank of England would be committed to taking on the responsibility for some or all of these floors and consequently some or all of this liability may transfer to the Bank of England.

Leasehold improvements and cabling

The £3.8m contingent liability (leasehold improvements £3.2m, furniture and fixtures and fittings – cabling £0.6m) represents the forecast net book value of 1 Canada Square assets as at 1 March 2013, the current working date for legal cutover. If the regulatory reform legislative process completes, some or all of these assets may need to be impaired, subject to the results of the property portfolio re-organisation discussed above.

Regulatory transition costs

In addition to the contingent liabilities set out in the table above, if the regulatory reform legislative process completes, the FSA will be committed to incur transition costs (full details of which are set out below), currently estimated at £32.5m in 2012/13. All of the 2012/13 costs have been budgeted for and taken into account when setting the FSA's Annual Funding Requirement (AFR) and are detailed in our published Business Plan 2012/13.

The £32.5m cost is not wholly contingent upon the legislation being passed, as some of the transition costs are being incurred and committed to in advance of legislation being passed in order for preparation for legal cutover to be well advanced.

The FSA's transition costs include amongst other things:

- incremental staff costs to project manage and deliver the transition programme within an appropriate governance structure;
- costs associated with identifying and making ready the infrastructure and information systems changes necessary to move to two separate legal regulatory entities;
- re-stacking the FSA's property portfolio to accommodate the transfer of staff to the PRA;

- re-designing the supervisory processes and rule-books and training staff to deliver dual regulation of firms; and
- professional fees (legal, information systems, property specialists) to assist the FSA in the delivery of a technically complex transformation programme.

At this stage, the total estimated costs of transforming the FSA into the FCA and establishing the PRA are between £130m and £175m.

20. Notes to the cash flow statement

	Notes	2012 £m	Restated[1] 2011 £m
Surplus for the year from operations		35.9	30.3
Adjustments for:			
Interest received on bank deposits		(1.8)	(1.6)
Amortisation of other intangible assets	9	15.9	10.7
Impairment loss on intangible assets	9	5.4	3.7
Loss on disposal of intangible assets	9	0.6	-
Depreciation of property, plant and equipment	10	16.4	13.8
Loss on disposal of property, plant and equipment	10	0.2	0.1
Impairment loss on tangible assets	10	0.4	-
Profit on disposal		(12.8)	-
Decrease in provisions	14	-	(0.9)
Difference between pension costs and normal contributions	15	4.2	2.3
Additional cash contributions to reduce pension scheme deficit	15	(19.5)	(14.0)
Increase on unfunded pension liability	15	-	0.2
Operating cash flows before movements in working capital		**44.9**	**44.6**
Increase in receivables	11	(15.4)	(0.8)
(Decrease)/Increase in payables	12	(31.8)	88.8
Net cash generated from operations		**(2.3)**	**132.6**

1 Restated – The prior year figures have been restated to show surplus for the year from operations before tax, in line with IAS 7

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The following appendices will appear on our website only:
www.fsa.gov.uk/Pages/Library/Corporate/Annual/ar12-12-appendices.shtml

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Appendix 7 Data

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