Financial Services Authority

# Annual Report 2008/09

Promoting efficient, orderly and fair markets

Helping retail consumers achieve a fair deal

Improving our business capability and effectiveness

**Financial Services Authority**
**Annual Report**
**2008/09**

**Our objectives are:**

**market confidence:**
maintaining confidence in the financial system;

**public awareness:**
promoting public understanding of the financial system;

**consumer protection:**
securing the appropriate degree of protection for consumers; and

**the reduction of financial crime:**
reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

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 2008 to 31 March 2009.

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 the 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 ended 31 March 2009 are included in Section Six.

Additional material on our performance in 2008/09, including high-level indicators, can be found on our website at: **www.fsa.gov.uk/Pages/Library/Corporate/Annual/Index.shtml**

The Annual Report will be discussed at our Annual Public Meeting on 23 July 2009.

There are further details of our Annual Public Meeting on our website:
**www.fsa.gov.uk/Pages/Doing/Events/events/apm.shtml**


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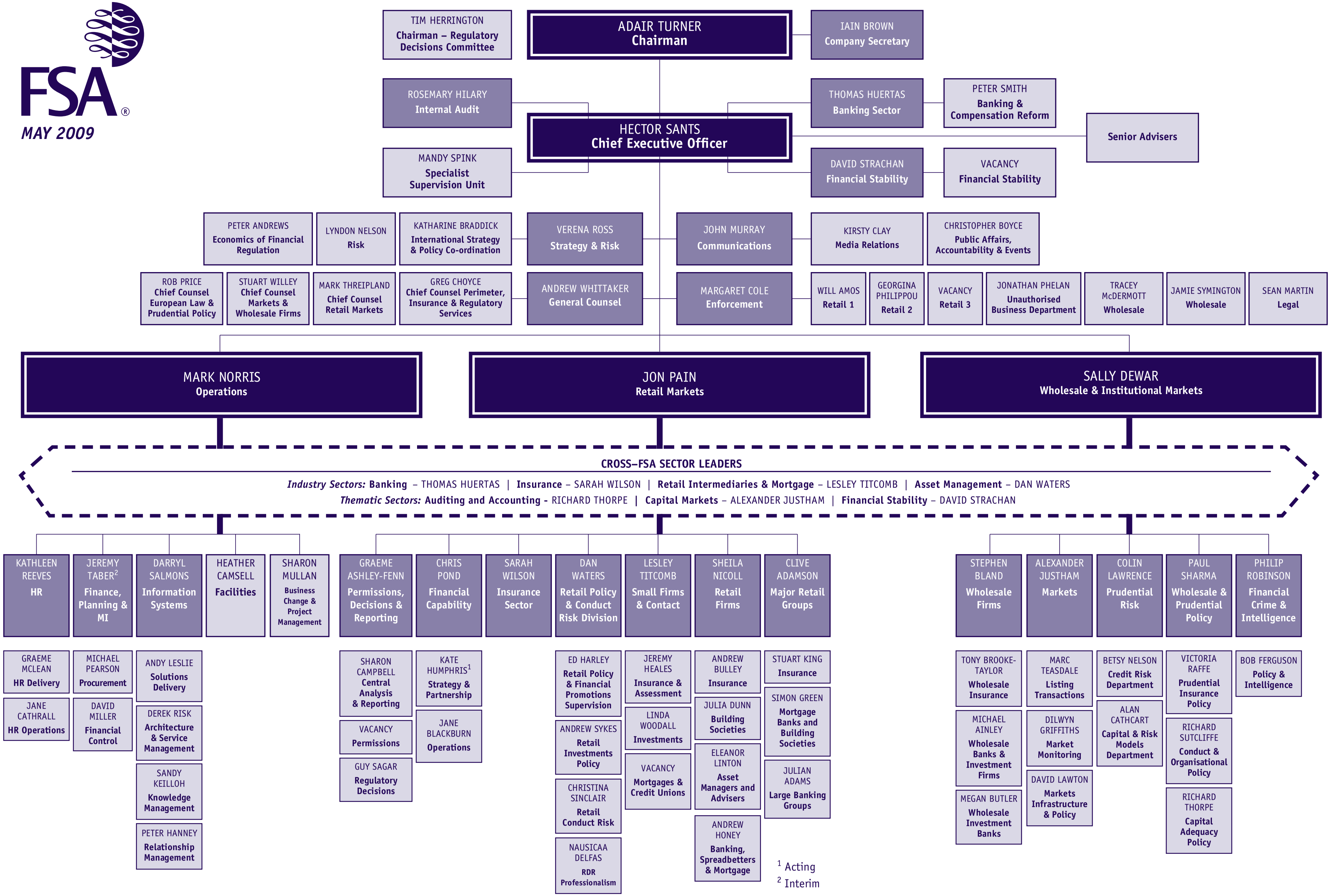



[1] Acting
[2] Interim

# Chairman's statement

Lord Turner, FSA Chairman

Over the last 18 months and with increasing intensity after September 2008 the global financial system has suffered a huge crisis, certainly the worst for 70 years. Severe problems emerged in bank and bank-like institutions in many countries simultaneously: the ability of the banking system to extend credit to the real economy has been impaired: and as a result global economic growth has turned negative for the first time since the second world war, with many developed countries, including the UK, suffering major recessions.

The year 2008/09 has therefore been an extremely difficult one for regulators across the world. I became Chairman of the FSA half-way through that year, and my first six months coincided with the most extreme phase of the crisis. I joined an FSA working very hard to address the huge challenges we faced. Looking at 2008/09 as a whole, I believe the FSA has dealt successfully with the immediate crisis, and taken actions to ensure that we build a more stable financial system for the future.

The FSA's Annual Report has for several years been organised around three strategic aims: 'Promoting efficient, orderly and fair markets', 'Helping customers achieve a fair deal', and 'Improving our business capability and effectiveness'. This year's report maintains this structure, but starts with a chapter on 'Financial stability and supervision of firms – responding to the crisis.' This reflects the vital importance of these issues over the last year, and the large proportion of senior management time which has had to be devoted to the challenges – both short and long-term – of ensuring financial stability.

Financial stability was not explicitly defined in the Financial Services and Markets Act as one of the FSA's statutory objectives: arguably it should be one. But it is certainly implied by one of the four statutory objectives which are set out – 'Maintaining confidence in the financial system'. And all of the FSA's activities over the year 2008/09 have been focused on meeting this and our other three statutory objectives. It is therefore useful to comment on our performance under these headings.

## Maintaining confidence in the financial system

Between mid 2007 and mid 2008 confidence in the global banking and financial system declined: then, after the failure of Lehman Brothers in September 2008, it suffered a dramatic collapse, requiring exceptional interventions in mid October. Clearly this implies that financial authorities in total – finance ministries, central banks and regulators, including the FSA – must have made what in retrospect were serious mistakes. Our challenge over this year has therefore been to address the immediate crisis and to start building a better system for the future.

Crisis management activities have seen the FSA play the leading role in dealing with actual or potential failure in particular institutions: the Report sets out details of these operations, which have created exceptional workloads for particular groups of staff and have been delivered to a high professional standard. The crisis has also involved the FSA working intensely with our Tripartite partners in debating the options for system-wide policy interventions – such as the Bank Recapitalisation Scheme, the Credit Guarantee Scheme, and the Asset Protection Scheme – and in implementing these initiatives. These measures have stabilised the financial system and laid a sound base for the return of confidence.

But the full return of confidence will only occur slowly: the last year has brutally reminded us how vital confidence in the banking system is, how potentially fragile, and how harmful is its loss. It is therefore crucial that we also take steps to create a more robust system for the future. Two major FSA initiatives have been designed to ensure this. These have been:

- The Supervisory Enhancement Programme, which was launched six months before I joined as Chairman, and which will result in a major shift in the FSA's supervisory approach, particularly but not exclusively in relation to high-impact banks and bank-like institutions. Hector Sants' CEO report and Section One of this document describe this vital programme, which is well on the way to full implementation.

- A detailed analysis of the causes of the financial crisis and a comprehensive review of the regulatory policy. This resulted in March 2009 in the publication of *The Turner Review*, which proposes fundamental changes in our future approach to capital, liquidity and accounting, and to the regulation and supervision of credit rating agencies, hedge funds, and large cross-border and complex banks. The FSA is now developing detailed implementation plans for those reforms which we can pursue alone. And we are intensively involved in the Europe-wide and global debates (within, for instance, the Financial Stability Board and the Basel Committee on Banking Supervision) which will result in Europe-wide or global agreements on the way forward.

Much of our focus over the last year has inevitably been on the major immediate problems and these have been in the banking system. But the FSA has also been intensively involved, as the Report sets out, in addressing prudential issues relating to the insurance sector. We have dealt with potential short-term stresses arising from the banking crisis: and have been actively involved in achieving a sound European prudential framework, where the Solvency II Directive will play a crucial role.

## Securing the appropriate degree of protection for consumers

FSMA also sets the FSA a consumer protection objective. Maintaining financial stability and confidence is in itself a crucial means by which we pursue this objective: and it is important to note that no retail depositor at a UK bank has lost money during this financial crisis. The improvements to our regulatory and supervisory approaches outlined above will minimise the likelihood that maintaining that record in the future requires a repeat of the public finance support which has been required over the last year. Reforms to the deposit protection scheme, some of which we have already implemented, and on some of which we are now consulting, will also play a key role in this regard.

But the way in which firms conduct their business is also crucial. The Report describes a number of successful conduct initiatives, such as our work to tackle mis-selling of payment protection insurance (PPI). It also describes the progress of the Retail Distribution Review. Over the last two years the FSA has been involved in an extensive period of research and consultation to inform a redesign of the rules relating to the distribution of retail investment, insurance and pension products, aiming to achieve a step-change in the industry's ability to serve the real needs of customers in a cost-effective, transparent and fair fashion. The policy development stage is now complete, and we will implement the changes over the next year.

## Promoting public understanding of the financial system

The FSA's commitment to this objective and the expectations placed on us by government have increased significantly over the last several years. Our financial capability work now involves a wide range of activities, encompassing information, education and guidance initiatives with: schoolchildren; young adults not in employment, education or training; students in further and higher education; employees in the workplace; new parents; more vulnerable consumers reached through our work with non-profit organisations; and the money guidance pathfinder – branded *Moneymadeclear* – delivering online, phone and face-to-face services. These are described in Section Three. Over the coming year, we will develop more initiatives to help adults make sensible financial decisions through the recession. Results from the regional pathfinder of *Moneymadeclear* will help inform the future of a money guidance national service, the need for which is ever more pressing.

## Reduction of financial crime

During the past year, we have demonstrated our resolve to bring credible deterrence to bear on financial crime. On tackling market misconduct, we secured two convictions and a custodial sentence in our first ever insider dealing criminal trial – a clear warning that wrongdoers who cheat the market will be held to account. We have taken action against share sale frauds (boiler rooms) and mortgage fraud in conjunction with the City of London Police. We fined or prohibited 22 mortgage brokers for fraudulent activity (rising from 11 in 2007) and have referred a number of cases to the police leading to a significant number of arrests in the last year.

Financial crime is an international problem and the FSA has continued to support international solutions ranging from policy development on anti-money laundering with the Financial Action Task Force and the EU to increased engagement with international law enforcement partners for the purposes of intelligence sharing. Since prevention is the first step in fighting financial crime, we have continued to carry out and publish thematic reviews of firms' financial crime controls and we continue to keep persons of doubtful integrity out of the financial system.

The activities described above have placed huge demands on FSA staff over the last year, both as we have responded to the crisis, and as we have implemented major changes to improve our future effectiveness. I would therefore like to thank all of the staff for their hard work and professionalism in what have been often stressful times.

The year 2008/09 has also placed exceptional demands on the non-executive members of the Board, who have responded with alacrity to numerous emergency Board meetings, and provided excellent counsel to the Executive in relation to both short-term challenges and long-term priorities. I thank them for their hard work and commitment. My thanks and those of the Board should also be recorded to Sir James Crosby for his significant contributions to the Board prior to his resignation in February. And among our Executive Directors, David Kenmir has left the Board at the end of March after ten years of very strong contributions to the FSA, as Managing Director (MD) of Operations and for a time as MD of the Retail Business Unit.

Finally in a report which covers a full year of the FSA's work, it is important to remember that the FSA was chaired for the first six months by Sir Callum McCarthy, who contributed greatly to the FSA's response to the growing crisis and worked with Hector Sants to put in place many of the changes in FSA approach which have subsequently been further refined. I would like to thank him for all his contributions over five years as Chairman of the FSA.

Adair Turner

Lord Turner

# Chief Executive's report

Hector Sants, FSA Chief Executive

As you know, the last year has been extremely difficult for financial markets and consequently the FSA has been stretched in discharging its statutory responsibilities. Overall we have responded and adapted well to events and also laid the foundations for a restoration of confidence in the wider financial system.

Over the past year, as you would expect, our principal focus has been on managing the consequences of the financial crisis, as well as modernising our supervisory practices and laying out proposals for change to the regulatory architecture. However, it is important to recognise the FSA, as a whole, has a wide set of responsibilities which extend well beyond deposit taking institutions. A review of our overall work over the last 12 months can best be described in relation to the following principal objectives:

- Managing the consequences of the financial crisis in terms of the firms we supervise and their customers.
- Introducing our intensive supervisory approach through the Supervisory Enhancement Programme (SEP), which launched in April 2008. This new approach is underpinned by our credible deterrence philosophy.
- Laying out our proposals for changes to our bank prudential regulatory framework while also continuing to deliver our long-term wider policy agenda, in particular in respect of the Solvency II Directive.
- Ensuring we maintain focus on key conduct risks and establishing a new approach to conduct regulation.
- Continuing our work on financial capability, which provides consumers with resources to help them stay in control of their finances, in particular launching *Moneymadeclear*, an online impartial finance information service.
- Continuing to ensure efficient, fair, orderly trading markets which included managing the interrelationships between exchanges and consumer confidence in relation to quoted financial firms.
- Continuing to make the necessary improvements to our organisational effectiveness, ensuring we are staffed by the right people in the right jobs and have the right infrastructure.

Before reviewing our performance in relation to these objectives, I would like to comment on a development during the year that is vital to the long-term success of the organisation – namely modernising our regulatory philosophy. Our revised approach reflects our analysis of the crisis and incorporates some of my fundamental views on regulation.

Historically the FSA's regulatory philosophy was described as 'principles-based'. I continue to believe that we must emphasise the value of encouraging individuals to judge their behaviour against principles as opposed to prescriptive rules. However, I believe it is more instructive to focus on the need to judge individuals on the consequences of their actions. This has led us to revise the description of our philosophy to 'outcomes-focused regulation'.

The more important change, however, is to the way we apply this philosophy. Previously it was applied by focusing on ensuring that firms had systems and controls and relying on management to make the right decisions. We are now focusing on questioning the overall business strategy of the institution and more generally on the possibility of risk crystallising in the future. This is a fundamentally different way of supervising firms. We are now making judgements on the judgements of senior management and taking action if, in our view, those decisions will lead to risks to our statutory objectives. We believe this move from regulation based only on observable facts to regulation based on judgements about the future is vital to help us deliver our statutory objectives.

## Responding to the financial crisis

The specific actions we have taken to respond to the issues raised by the financial crisis have been commented on by our Chairman and are set out in more detail in Section One of this Report. I would, however, like to emphasise that the effect of the crisis on a firm is largely determined by the business model the firm had at the onset of the crisis in 2007. Our work during the last few months has been to mitigate those effects and begin the long-term practice of helping firms modify their business models to take into account the structural changes that have occurred in the system.

Our work to reduce the impact of the crisis from the supervisory perspective can be looked at as having three elements. First, we have taken the lead within the Tripartite Authorities for ensuring we have a full understanding of the major firms' business models and asset characteristics. The central mechanism for achieving this has been far more intensive stress-testing than was previously used in our supervisory process. Second, we worked with the Bank of England and the Treasury to deliver the necessary recapitalisation to ensure there are sufficient capital buffers to address the asset quality problems. Third, where these interventions were not sufficient to ensure the long-term viability of an institution, we worked with the Bank of England and the Treasury to seek to ensure a resolution for the relevant failed institution in a way that minimised the impact on consumers and delivered best value for tax payers.

From 21 February we were able to utilise the new Banking Act 2009. The framework established in the Banking Act has, I believe, been shown to be extremely efficient. Our work, in seeking to achieve private sector solutions, has also been central in providing the maximum range of options for the resolution process.

## Intensive supervision

When I took on the CEO role, I made clear my intentions to change radically the supervisory approach of the FSA. I set out to ensure that the FSA is seen as a regulator which delivers 'intensive supervision' and 'credible deterrence'. That programme began 18 months ago and we are well on track to achieve that goal by the end of 2009.

The key element of this change has been the implementation of the SEP. This programme is characterised by greater supervisory resource, of a higher quality, delivering a more intensive and intrusive approach. We are on course to hire, by the end of 2009, 280 extra specialist and supervisory staff, which will represent an increase of over 30% in our supervisory capacity.

The FSA is now a radically different organisation to that which existed prior to the summer of 2007. We have dramatically increased the number and quality of our supervisory staff and as a result have significantly increased the intensity of our oversight of major firms.

During 2008/09 we:

- recruited 184 staff as part of our SEP recruitment campaign – made up of 144 supervisors and 40 specialists, of which 136 are external and 48 are internal hires, reaching 66% of our target recruitment by the end of April 2009;
- raised the number of dedicated supervisory staff to 703, compared to 526 at the end of 2007/08 – this is an increase of 33.7%;
- increased our contact with firms through supervisory activities by approximately 47%;
- ensured 75% of external new hires at the associate level have at least ten years of relevant work experience;
- introduced a new Training and Competence (T&C) scheme to ensure that our staff are properly equipped to do this job, which involves a regulatory testing regime for existing supervisors;
- began changing our authorisation process for Significant Influence Functions (SIFs) to ensure we are judging competence and regulatory knowledge as well as probity;
- reorganised and strengthened our risk identification and mitigation capacity, particularly our sector analysis and specialist support for prudential and conduct risk mitigation;
- revised the supervisory risk assessment framework to include greater focus on business models and to embed stress testing based on our own assumptions as an ongoing part of the process; and
- increased our engagement with auditors and investors to emphasise their role in the oversight of firms.

## Credible deterrence

Our more intrusive and intensive style of supervision complements our proactive approach to enforcement – the credible deterrence philosophy. Since we set out this philosophy last year, we have demonstrated that we will use all our powers, including criminal prosecutions, to deliver our mandate. Our commitment to credible deterrence is supported by the facts that:

- in 2008/09 we imposed financial penalties of £27.3m which compares to the 2007/08 figures of £4.4m;
- we prohibited a record number of individuals (58) from the industry for unacceptable conduct ranging from market abuse to mortgage fraud or failing to adhere to the Treating Customers Fairly guidelines; and
- we secured two convictions and a custodial sentence in our first criminal prosecution for insider trading.

We will continue to pursue this aggressive approach as part of our commitment to reduce financial crime and protect consumers.

## Policy agenda

*The Turner Review* and associated Discussion Paper, published on 18 March, was a major step forward in analysing the causes of the crisis and laying out the steps necessary to modernise the banking policy regulatory framework. We have also initiated the required programme to take this agenda forward, as commented on in our Chairman's statement.

Despite having to commit significant resources to the key issue of modernising the banking regime we were still able to meet 45 of the 54 milestones that we set out in our 2008/09 *Business Plan*. Seven of the nine were missed due to deliberate reprioritisation. We have continued to collaborate with domestic and international partners to develop key policy initiatives; this includes work on reforming banking regulation, particularly in relation to capital and liquidity requirements, credit rating agencies, consumer protection and the Solvency II Directive.

## Conduct risks

During the last 12 months we have maintained the required focus on consumer protection and in particular on our Treating Customers Fairly agenda. We have embedded this in our regular supervisory activities and also focused on the major areas of specific consumer detriment, including the sale of payment protection insurance and personal pension transfers.

## Financial capability

We carried out work to provide consumers with resources to help them stay in control of their finances including launching, in partnership with the Treasury, *Moneymadeclear*, an online impartial finance information service. As part of our wider strategy in this area, in 2008/09 we met 37 of 45 and exceeded 13 consumer education targets. We also provided 3.5m people with personal finance information, guidance and education.

## Markets

In the markets area we continued to deliver an efficient and effective listing oversight and during 2008 we approved just over 1,900 prospectuses. We also made a series of interventions in relation to short selling, to minimise the impact of disorderly markets on financial stability. We also, as part of credible deterrence, continued our enhanced enforcement activity in respect of unlawful market conduct. A notable success here was our first criminal prosecution for insider dealing.

## Operational effectiveness

In this period we continued to improve our operational platform which is critical to an effective analysis of risk and ensured we are operating in the most effective manner. A key component of this was the delivery of our GABRIEL reporting systems in August 2008.

As I mentioned before, to carry out our new approach to supervision we have had to increase significantly the supervisory resource we apply to the major firms and ensure our supervisors have excellent industry knowledge and sound judgement. We believe we have made good progress on this agenda over the last 12 months, both in terms of getting the right mix of both regulatory and market experience.

As we have hired more staff, it has been critical for us to continue to improve the quality and ensure effective recruitment and retention. This is supported by the development and implementation of the T&C scheme and our commitment to providing staff with an effective and competitive remuneration package. These initiatives have been supported by the ongoing commitment to develop the leadership skills of all our senior staff.

I believe, particularly in a not-for-profit organisation, that it is essential to have a mechanism for encouraging individuals to contribute at the highest level. In particular it should be noted that our staff do not receive overtime and many have worked throughout nights and weekends and forgone holidays during the past year. The FSA does not pay 'bonuses' in the sense of general profit-related distribution to staff. It does, however, operate a 'total compensation' system whereby individuals are eligible to receive individual performance awards where justified by a rigorous individual appraisal process.

The sum of money made available for these individual pay incentive awards is equivalent to 14% of our salary bill for 2008. This equates to £19.7 million, which is less than 6% of the total cost of the FSA in that period. These payments were made only where they were merited and are essential to ensure the organisation can retain and attract the right calibre of staff.

In the long term we believe it is important that we have a consistent approach to remuneration for our employees. Currently, however, there are discrepancies between employees' remuneration policies as some 20% of staff remain in a final salary pension scheme. We are therefore consulting on closing it, which is a key element of delivering a fair reward strategy for the organisation as a whole.

## Conclusion

I recognise that many in society feel let down by the regulatory system and thus the regulator. I and my colleagues have tried to be open and honest about the shortcomings of the regulatory system while also making clear the limitations of a national supervisor. It is critical to understand that the individual firm problems we have seen emerge in the last year had their origins in the boom, and were not reversible in the current market conditions. Our objectives in the past 12 months have been to minimise the impact on users of these weaknesses and to lay the foundations of a more effective and better regime for the future.

I believe we have made good progress in extremely difficult conditions in pursuit of these goals.

Furthermore I hope we have begun the process of rebuilding confidence in the system and the regulator by demonstrating that we are an organisation that is willing to learn and that we have the ability to change radically. I believe enduring and respected organisations are forged in times of adversity and that this will ultimately be seen as such a time for the FSA.

Hector Sants

# Financial stability and supervision of firms – responding to the crisis

## INTRODUCTION

The FSA's *Business Plan* for 2008/09, published in February 2008, set out the initiatives we planned to deliver and complete during the past year. In previous years the FSA's *Annual Report* has been structured around explaining our progress in delivering the *Business Plan*, and Sections Two to Four of this report review that progress. The financial crisis has however required a major shift of focus, including the design and implementation of measures not anticipated in the 2008/09 Business Plan, and the development of radically changed approaches to supervision and regulation. This section therefore describes our response to the crisis covering:

- the actions taken to deal with the crisis and stabilise the financial system;
- actions to redesign our supervisory practices to better equip us to contain future risks; and
- our work to develop new approaches to financial regulation, in the UK and internationally.

These changes have been an essential response to a crisis centred on banks and investment banks, but the shift in supervisory style will apply to all high-impact firms. Regulatory changes relating to insurance companies (e.g. Solvency II) are covered in Section Two.

## DEALING WITH THE CRISIS

Very significant resource and top management attention was devoted over 2008/09 to the task of identifying and dealing with the problems of specific firms, and in the autumn of 2008, with designing and implementing measures to stabilise the entire banking system. In the course of this work we have developed new approaches to analysis and supervision which will be embedded in our more intensive approach to supervision over the long-term.

Our work in this area can be understood under three headings:

- First, we have lead the work of the Tripartite Authorities to ensure that there is a full understanding of the risks facing major firms. This has required the development of a far more intensive stress testing regime than our routine supervisory approach had previously involved, the development of a new transitional capital regime[1] and more intense scrutiny of firm accounting practices and judgements.
- Second, we have worked with the Treasury and the Bank of England to find solutions to the challenges of the whole banking system, helping design and implement the bank recapitalisation and asset protection schemes.
- Third, we have worked with the Treasury and Bank of England to resolve the problems of individual firms, seeking private sector solutions where possible and ensuring orderly resolution where not.

### Stress testing, new capital regime, accounting practices and supervisory judgements

The crisis has required us continually to assess the financial health of banks and building societies so as to identify emerging problems. This has entailed far more detailed scrutiny of the asset quality, earnings potential and liquidity position than we had routinely conducted in the past.

1 In common with financial regulators across the world, the FSA needed to act rapidly to create a new regime in the face of the financial crisis. It will stay in place until replaced by a new internationally agreed regime. Possible features of such a regime and the mechanisms for achieving international agreement are discussed when we address the development of the long-term policy framework later in this section.

This analysis has then been used to inform stress testing to identify the ability of firms to sustain adequate capital and liquidity on a forward-looking basis and in the face of severe macro-economic conditions. It has also required the FSA to become more involved in the scrutiny of specific accounting practices and judgements.

The level of detail involved in our stress testing approaches increased dramatically as the crisis progressed.

- In October 2008, as the severity of the banking crisis became apparent, we rapidly conducted an initial stress-testing exercise working closely with the Bank of England. This required several major UK banks to estimate the potential impact of a common macro-economic scenario, basing their analysis primarily on internal models and methods. We simultaneously put in place a new capital adequacy framework, requiring banks to hold a 4% minimum level of core tier 1 capital after the impact of the stress test. Where necessary the government provided a capital injection.

- We have subsequently greatly increased the intensity of our stress-testing techniques. These tests have informed specific decisions such as banks' access to the Asset Protection Scheme and building societies' access to the Credit Guarantee Scheme, and have now become an integral element within our ongoing supervisory approach. The stress tests analyse all the relevant variables affecting an institution's capital adequacy, including revenue generation potential, the probability of default and possible losses given default within the loan book, and possible declines in the market value of assets held in the trading books. They now draw on FSA valuation models and adjustments as well as firm analysis reviewed by us. They look forward to identify if at any time over a five-year period there is a danger that under the stress scenario the level capital will fall below the 4% core tier 1 minimum. And they are based on a macro-economic scenario, agreed by the FSA and the Bank of England which is deliberately designed to be more severe than is expected to arise.[2]

- At the end of 2008 we asked the major life insurance groups to assess the impact of a variety of different stress tests on their Pillar 1 capital position at both group and entity level. In 2009 we asked all life insurers to assess the impact of a particular macro-economic scenario on their ability to meet Pillar 1 and Pillar 2 capital requirements.

In future, stress testing will become a critical part of our supervision process. We published a Consultation Paper (CP) in December 2008 setting out proposed changes to our Handbook rules and guidance on stress and scenario testing. We proposed to introduce a 'reverse-stress test' requirement, which would apply to banks, building societies, CRD investment firms and insurers, and would require firms to consider the scenarios most likely to cause their current business model to become unviable. We also proposed to make some drafting changes to our existing requirements on Pillar 2 capital stress and scenario testing, or where firms use internal models to assess their Pillar 1 capital requirements.

The proposed changes are intended to reflect more clearly the importance that we attach to robust stress and scenario testing and clarify our expectations of firms. The changes will affect our provisions on Senior Management Arrangements, Systems and Controls and our prudential sourcebooks. We will provide industry with the feedback on conclusions from our supervisory and evaluation process reviews to date, as well as EU and international work on stress and scenario testing.

One crucial input to stress-testing is, of course, detailed understanding of the assets currently on the balance sheet, of their accounting treatment and of variations in accounting practice. Increasingly from the autumn of 2008 onwards, we were therefore intensively involved in the analysis of bank balance sheets to inform decisions on bank recapitalisations and the Asset Protection Scheme (APS). This analysis has revealed significant differences in the marks used by different banks to value similar trading book assets and significant differences in the allocation of assets between trading and banking books. We have not in the past monitored these accounting policies as closely as now seems appropriate. A new approach is now being implemented,

2 Since stress testing has become a part of our ongoing supervisory approach, rather than a one-off exercise, the macro-economic scenario used will vary over time, and it is not the current intention of the FSA to provide a continual update in future of each change in the macro-economic scenario used. Given, however, the particular focus on the role of stress tests over the last few months, we did issue a statement on May 28 2009, setting out the macro parameters currently in use. It assumes a peak-to-trough fall in GDP of over 6%, with growth not returning until 2011 and only returning to trend growth rate in 2012. It models the impact of unemployment rising to just over 12% and, crucially, the impact of a 50% peak-to-trough fall in house prices and a 60% peak-to-trough fall in commercial property prices.

entailing detailed FSA comparative review of the judgements made by different banks, meetings with management and auditors to explore the reasons for outlier positions, and the agreement with firms of the adjustments to policy required.

## Stabilising the banking system: recapitalisation and the Asset Protection Scheme

When major banks were unable to demonstrate that they had sufficient capital to withstand major stress tests, the Tripartite Authorities agreed that they should be recapitalised with the benefit of capital provided by the Treasury. The aims of this intervention were to protect the interests of consumers, to ensure the stability of the banking system and to support its ability to provide credit to the real economy.

The Tripartite Authorities announced in October 2008 that they would implement a comprehensive £500 billion plan to support the UK banking system. The plan addressed capital and funding liquidity together. The plan:

- doubled the funds available for the Bank of England's Special Liquidity Scheme to £200 billion;
- instituted a guarantee programme of approximately £250 billion for new wholesale debt issuance by banks that either already had or had a plan for raising tier 1 capital in the amount and in the form the Tripartite Authorities consider appropriate; and
- indicated that the government had allocated at least £50 billion to act, if need be, as an underwriter or capital provider of last resort to enable banks to meet the capital standard required for participation in the Credit Guarantee Scheme.

In February 2009 the government took another step to respond to the crisis by announcing its **Asset Protection Scheme**. The scheme forms a significant part of its measures to deal with the financial crisis. The scheme is designed to provide protection against credit losses occurring on specified pools of assets above a certain threshold (the first loss). It is intended that the scheme will target risky and uncertain assets, including those that are most likely to be adversely affected by economic conditions. The Treasury will reimburse the participating firm, for a portion (usually 90%) of all losses that exceed this first loss amount. The scheme will affect the capital position of any participating group. Specifically, the first loss portion that is retained by the participating group will be met with a deduction from capital, but the risk-weighted assets of the protected portfolio will be significantly reduced.

We worked closely with the Treasury and Bank of England on the application of the scheme, and in particular provided advice on the design, pricing and the assets to be included – as well leading the required stress testing as commented earlier.

## Managing and resolving distressed financial institutions

When it proved impossible to find market solutions, we have worked with the other members of the Tripartite Authorities to ensure that an orderly resolution was achieved. This often involved partial sale or transfer to other financial services firms to best protect consumer deposits and help maintain stability.

We are charged with seeking to facilitate private sector solutions to address potential failing institutions and during the year we were very active in discharging this mandate in a variety of different situations. For example, we used our 'directed merger' powers in Section 42 of the Building Societies Act 1986 (BSA 1986) to allow several building society mergers to take place by board resolution rather than members' vote. Given the uncertain economic climate, this course of action was deemed to be in the best interests of members. In the case of Bradford & Bingley, London Scottish Bank, Dunfermline Building Society and the UK subsidiaries of the Icelandic banks – Heritable Bank plc (Landsbanki) and Kaupthing, Singer and Friedlander (KSF) Ltd (Kaupthing) and the UK branch of Landsbanki (which provided Icesave accounts) – no merger partners or acquirers were available on solely commercial terms. However, the work we did to identify possible private sector solutions was central to identifying potential bidders who subsequently participated in resolution processes.

We were fully and actively involved in Tripartite discussions which led to the decision in September 2008 that **Bradford & Bingley** could not continue in its current form. We concluded that Bradford & Bingley was in breach of its threshold conditions, namely that it no longer met regulatory capital and liquidity requirements and that it could not continue to operate on a sustainable basis. The government decided to exercise powers to protect savers' money by selling the savings business to Abbey National plc, a subsidiary of Banco Santander. Bradford & Bingley's other businesses, including mortgages and loans, were placed into temporary public ownership in order to move towards a satisfactory long-term solution.

In November 2008 we decided that **London Scottish Bank** should be prevented from accepting further deposits as it no longer met our threshold conditions. It was placed into administration by the Court on the application of its directors. As a result of the bank's administration, the Financial Services Compensation Scheme (FSCS) was triggered to safeguard retail deposits. The FSCS put arrangements in place to pay back customers and provided further information for customers. Eligible retail depositors were compensated through the FSCS, with the Treasury protecting balances above the current UK deposit limit of £50,000.

We took steps to address our ongoing concerns over the stability of **Dunfermline Building Society**. After intensive contact over a number of months between us and Dunfermline to find a workable, private sector solution, in March 2009 the Board of Dunfermline concluded that the Society was unable to continue as a going concern and advised us accordingly. As a result we decided that Dunfermline was likely to fail to meet the adequate resources threshold condition and that there was no other option available that would have enabled Dunfermline to satisfy the threshold conditions. This decision gave rise to the Special Resolution Regime (SRR) being invoked, which is a key component of the Banking Act 2009. After following the process under the SRR an agreement was reached to transfer Dunfermline's savings business and branch network, most of its residential mortgage and the personal loan businesses to Nationwide Building Society.

In October 2008 we determined that **Heritable and KSF** no longer met their threshold conditions and that they were in default for the purposes of the FSCS. The Treasury used powers under the Banking (Special Provisions) Act 2008 to ensure a resolution that preserved financial stability and provided protection and continuity for depositors. Most of Heritable's retail deposits and KSF's Edge deposits were transferred to ING Direct. Following due legal process, the remainder of Heritable's and KSF's businesses were put into administration.

In October 2008 we also announced that the UK-based branch of **Landsbanki** was in default for the purposes of the FSCS. The Treasury guaranteed that all retail depositors with Icesave would receive their money in full through the FSCS and also agreed to finance the reimbursing of deposits above £50,000, which are not covered by either the Icelandic Deposit Guarantee Scheme or the UK's FSCS.

## REFORMING OUR SUPERVISION PRACTICES

In parallel with responding to the immediate challenges of the financial crisis, we have launched and are now well advanced in implementing a fundamental redesign of our supervisory practices.

The Supervisory Enhancement Programme (SEP), launched in April 2008 will result in more intensive and intrusive supervision of high impact firms. It will entail greater willingness to make judgements about the riskiness of business models and strategies, and to use prudential levers such as capital and liquidity requirements to require firms to reduce risks. It marks a major shift away from past FSA practice, applied in the years running up to the crisis, which focused primarily on the adequacy of firms' systems and controls. And it will entail greater scrutiny of the competence as well as the probity of key personnel ('Significant Influence Functions'). Alongside the required changes in the regulatory approach (described below) it will radically reduce the risks of a recurrence of the problems of the last two years.

The CEO's report sets out progress to date on the SEP. Key priorities have been:

### Resource

- We are over two-thirds of the way through our recruitment drive to appoint 280 extra specialist and supervisory staff. A key focus has been on ensuring that external recruitment fills specific skills or knowledge requirements to ensure the right mix of regulatory and market experience.

### Competence

- We have upgraded our Training and Competence (T&C) scheme for most relationship-management supervisors – in the coming year the scheme will be rolled out to all supervisors. The scheme includes eight core modules for existing supervisors and an updated induction programme for new supervisors. The T&C scheme requires supervisors to demonstrate competence across technical and behavioural competencies, sector-specific knowledge and skills, and on-the-job activities. The T&C scheme allows us to demonstrate to external stakeholders the ongoing competence of our supervisory staff.

### Tenure

- We have developed a tenure policy that will provide a framework for the minimum and maximum time a supervisor should manage the relationship with a firm. This will benefit firms by ensuring continuity of knowledge and experience.

### Risk identification

- Critical to effective supervision is risk identification. We are revamping our risk-identification process; in particular, by strengthening our industry-sector capability, which is designed to identify and analyse industry and overall risks, and equip our supervisors to work more effectively with firms to mitigate risk and assess business models.

## Technical support

- We have significantly strengthened our technical support on prudential and conduct issues by creating specialist areas for prudential and conduct risk, and we will continue to strengthen these areas in 2009/10. Our increased technical support resources in the prudential area have significantly enhanced our ability to conduct our own stress testing, to make our own assessments of asset valuation models and methodologies, and to analyse bank liquidity risks in detail.

Key elements of our redefined standard processes are:

- A compulsory and irreducible programme of regular meetings with the senior management, control functions and non-executive directors of high-impact firms (HIFs) subject to our 'close and continuous' regime.

- A maximum period between formal ARROW (advanced risk responsive operating framework) assessments of maximum two years for each HIF. In addition, in the period between ARROWs, we will now hold formal internal 'checkpoints' on a six-monthly basis to provide more FSA senior management input and oversight of the supervisory approach for the firm.

- A new group of supervision advisory specialists who will conduct a regular quality review of the supervisory process for all HIFs. It will also provide support to the supervisory teams.

- Increased scrutiny of candidates for Significant Influence Functions (SIFs – see below).

## Significant Influence Functions (SIF)

It is critical – not just for firms, but for market confidence – that major institutions are soundly run by individuals who have clearly demonstrated that they have the necessary skills, experience and integrity.

As part of the SEP, we said we would place greater emphasis on the role of senior management, including non-executive directors. We have therefore introduced interviews for candidates for a number of key functions in an authorised firm. The presumption is that any application submitted by a high-impact firm for the roles of Chair, CEO, Finance Director or Risk Director will result in an interview. Other SIF candidates may also be interviewed at the supervisor's discretion – for example, if there are concerns about the compliance culture of the firm or the track record of the candidate.

In the first six months of the enhanced approval process, 51 SIF interviews were carried out. In a number of cases applications have been withdrawn following interviews that raised questions concerning the candidate's fitness or competence. The focus on assessing key competencies, as well as matters of probity and past compliance record, represents a significant shift in our supervisory approach.

In December 2008 we published a CP clarifying our expectations of those within firms that perform a 'significant influence' function. The CP proposed we:

- extend the definition of the existing CF1 (director) and CF2 (non-executive director) controlled functions;

- clarify the role of non-executive directors within our Code of Practice for Approved Persons (contained in APER in our Handbook);

- extend the definition of the CF29 controlled function to include appropriate proprietary traders;

- amend the application of the approved persons regime to UK branches of third country firms so that all the controlled functions are applied; and

- extend the rule obliging firms to provide references for applicants of the CF30 (customer function) to all controlled functions.

We expect to publish a further statement on these proposals later in the year, alongside Sir David Walker's review on corporate governance which we discuss later in this section.

## DEVELOPING THE LONG-TERM POLICY FRAMEWORK

As well as responding to the crisis, and putting in place a fundamentally changed supervisory regime, the FSA has also over the last year been intensively involved in designing new approaches to bank prudential regulation, which will create a more stable future financial system. To implement some of these changes we will now need to secure international agreement: in some cases national implementation is to a degree possible and in some it has commenced.

## *The Turner Review*

As the banking crisis developed, the Chancellor of the Exchequer asked the newly appointed Chairman of the FSA, Adair Turner, to review and make recommendations for reforming UK and international approaches to the way banks are regulated.

In March 2009 we published *The Turner Review* and a supporting Discussion Paper (DP). The Review presented an in-depth look at the causes of the financial crisis, and identified the actions that the international community needs to take to enhance regulatory standards, supervisory approaches and international cooperation and coordination. The Review focused on long-term solutions rather than the short-term challenges. In its implementation plan it distinguished areas where we are already taking action (some of these actions are outlined later in this Section); those where the UK can proceed nationally; and those where we need to achieve international agreement.

The Review recommended:

- fundamental changes to bank capital and liquidity regulations, including more and higher quality bank capital (with much more capital required, in particular to support risky trading activity) and counter-cyclical buffers;
- national and international system-wide approaches to identify macro-prudential risks and to implement macro-prudential policy responses to complement stronger micro-prudential supervision;
- regulation of ‘shadow banking’ activities on the basis of economic substance not legal form, increased reporting requirements for unregulated financial institutions such as hedge funds and regulatory powers to extend capital regulation;
- regulation of credit rating agencies to mitigate conflicts of interest and ensure appropriate levels of transparency and monitoring;
- national and international action to ensure that remuneration policies are designed to discourage excessive risk-taking;
- major changes in our supervisory approach, building on the SEP plans already put in place last year, with a focus on business strategies and system-wide risks, rather than internal processes and structures; and
- major reforms in the regulation of the European banking market, combining a new European regulatory authority and increased national powers to constrain risky cross-border activity.

The accompanying DP gave further detail on these issues and discussed options for the necessary policy choices. It asked for feedback by 18 June 2009.

The recommendations of *The Turner Review* represent a radical shift in many aspects of bank regulation and recognised that many of the assumptions on which past regulatory approaches were based were wrong. There is significant international agreement on the broad direction of change, but designing and agreeing precise ways forward will require intense effort in which the FSA is now heavily engaged.

*The Turner Review* set out a detailed implementation programme and this section does not therefore duplicate those details. But we comment below on (i) key aspects of the emerging regulatory architecture globally and in the EU, which the FSA has been involved in designing and through which we now need to work (ii) specific areas of policy where we have been able to commence implementation, ahead of international agreement, including some areas where actions were already in hand before *The Turner Review’s* comprehensive consideration of the future regulatory regime.

### BUILDING A NEW REGULATORY ARCHITECTURE IN THE EU AND AT GLOBAL LEVEL

The future priorities for global financial regulation and the future organisational structure to ensure that these priorities are effectively addressed, have been a key focus of G20 leaders, with the UK leading the preparations for the London Summit in April 2009. The FSA has been an active contributor in the development of summit recommendations, participating in the overall UK Steering Group and in the Working Group on strengthened regulatory standards and transparency.

The April summit action plan endorsed the role of the Financial Stability Forum (FSF) as the key organisation charged with driving the global regulatory reform agenda. It also endorsed a widening of its membership to create a Financial Stability Board (FSB) to take account of the major changes in the global economy since the FSF started work in 1999. The FSA has been intensely involved in the work of the FSF over 2008/09. We have continued to lead the work of the FSB on the design and implementation of supervisory colleges, ensuring that international colleges are put in place for about 30 of the largest cross-border and complex financial firms. And we have been actively involved in developing FSF proposals relating to capital adequacy, liquidity, accounting practices and remuneration policies. These FSF policy proposals are closely aligned with those made in *The Turner Review*. Much of the work now needed to turn policy principles into detailed international agreements (for instance on a new capital adequacy regime) will now be taken forward by the Basel Committee on Banking Supervision, where the FSA is extensively involved.

Major changes in the European architecture for financial regulation and supervision are also now under discussion. The failure of the Icelandic banks, which (since Iceland is a member of the European Economic Area) had a right to operate as branches in the UK, with only limited FSA oversight of prudential issues, revealed that current arrangements are inadequate to ensure consumer protection on financial stability.

*The Turner Review* therefore recommended a fundamental change, creating a European Financial Services Authority, with significant powers to harmonise regulation, and to ensure peer review and challenge to supervisory practices, but with direct supervision continuing to be conducted at a national level. The Larosière report, commissioned by the European Commission, reached broadly similar conclusions, and its recommendations (see Box One) have now been taken as the basis for concrete Commission proposals. There remain, however, important issues of detail on which the FSA, alongside the Treasury, is now involved in detailed discussions.

Alongside this work on future structures, we have continued to be involved in the work of the existing three Lamfalussy Committees, Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR). We have been closely involved within CEBS in the Crisis Management Taskforce, and also on crisis management planning activities within the Banking Supervisory Committee of the European System of Central Banks.

### Box One: Responding to the de Larosière report

The de Larosière Group, chaired by Jacques de Larosière, was set up in October 2008 by the European Commission to make proposals on how European regulatory approaches should be changed in the light of the financial crisis. Sir Callum McCarthy, former Chairman of the FSA, was the UK member and the FSA made inputs to the Committee's deliberations through him.

The report, published in March 2009, argued for a significantly enhanced degree of coordination of European financial regulation and supervision. It recommended:

- The transformation of the existing Lamfalussy Committees (CEBS, CESR and CEIOPS) into regulatory authorities, with significant powers to foster good supervisory practice, but with supervision still primarily a national responsibility.
- The creation of a European Systemic Risk Council, led by the European Central Bank but with input from financial supervisory.

The broad direction of these recommendations is similar to that of *The Turner Review*, while differing in specific implementation details. The Report has now been taken as the basis for Commission proposals, published on 27 May 2009. The FSA is now actively involved, alongside the Treasury, in negotiations over the detailed proposals.

## PROGRESS ON IMPLEMENTING SPECIFIC AREAS OF POLICY

### Liquidity

The financial crisis has exposed the importance of liquidity risks. *The Turner Review* and associated DP set out a number of options for further change, including the introduction of a Core Funding Ratio, but the FSA has already launched proposals for a radical change in our past approach, and began gathering and analysing far more detailed liquidity data.

In December 2008 we published a CP, CP08/22 – *Strengthening liquidity standards*, which outlined a new framework for the prudential supervision of firms' liquidity risk, as well as best practices for measuring and managing liquidity risks.The proposed rules are based on recently agreed international liquidity standards, in particular the Basel Committee on Banking Supervision's Principles for Sound Liquidity Risk Management and Supervision, and they also take into account difficulties faced in the market over the past two years.

While it remains the responsibility of firms' senior management to adopt a sound approach to liquidity risk management, we proposed:

- a new, quantitative framework for liquidity risk management, which places greater emphasis on firms' ability to assess liquidity risks and develop policies to tackle them;
- a strengthened qualitative framework for liquidity risk management, with an increased focus on firms' stress testing and contingency funding plans;

- new liquidity reporting requirements; and
- a new approach to firms operating in the UK which are part of a wider international group, with greater focus both on liquidity held within the UK and on whole group liquidity.

The measures are designed to enhance significantly firms' liquidity risk management practices and will, in some cases, reshape their business models over the coming years. They will also improve our ability to monitor and supervise firms' liquidity risk exposures. The proposals will greatly improve firms' ability to deal with liquidity risks, and thereby increase the overall stability of the UK financial markets. They are likely to result in less reliance on wholesale market funding sources, and on very short-term deposits, whether retail or wholesale.

Ahead of the full implementation of the new approach, we have already put in place far more intensive information requirements on the maturity characteristics of assets and liabilities.

## Capital

*The Turner Review* and DP recommended major changes in the bank capital adequacy regime. These will build on work which was already in hand within the FSA and in international fora. In addition, we took action early in 2009 to make changes to the implementation of the existing Basel II regime to prevent unintended procyclical effects.

We continued our work on the **definition of capital.** We published a Feedback Statement (FS) in July 2008 following an earlier DP (DP07/6). We discussed various aspects of the DP with industry representatives, both bilaterally and through our Definition of Capital industry sub-group. The definition and quality of capital has become a major theme arising from the banking crisis as highlighted by *The Turner Review*. The DP has been an important driver of debate on capital, which has contributed to international reviews in Basel and the EU.

We published our findings and conclusions from a DP reviewing the interaction of our **solo and group capital requirements**. Although the responses did not provide conclusive evidence to support a change to our current regime, they raised some important issues that are relevant to other workstreams, including our wider work on the definition of capital, and we will take these into account where appropriate.

As the crisis developed over autumn 2008, it became apparent that the detailed implementation of the new Basel II capital regime could introduce unnecessary and unintended procyclicality beyond that inherent in any risk sensitive regime. We therefore launched an initiative to work with banks to facilitate a shift to a 'through the cycle' rather than 'point in time approach'. These changes will help reduce the extent to which capital requirements unintentionally increase in a recession, while maintaining appropriate focus on risks.

## Valuation and accounting issues

Valuation is an important aspect of firms' monitoring of capital adequacy. In the past year we have focused on helping firms improve their processes around valuing illiquid instruments. We have made it clear to banks that they should seek fair and independent valuation for structured finance and other illiquid products and ensure that controls are in place to provide clients with valuations that are clear and not misleading.

We undertook various pieces of work with individual firms who had significant positions in stressed asset classes about their valuation methodologies. We sent a Dear CEO letter to around 50 high and medium-impact firms that set out controls and standards we expected firms to meet, as well as good practices and areas for improvement based on our valuation work. We also contributed to the Basel Supervisory Guidance paper for assessing banks' financial instrument fair-value practices.

During 2008 we looked at ways to improve valuation disclosures in banks' financial statements. This had been identified as an important way of mitigating risks associated with **valuation uncertainty**, which arose from the difficulties in the application of fair value accounting when an active market does not exist. We worked closely with the Senior Supervisor Group (SSG), which published the guidance report *Leading Practice Disclosures for Selected Exposures* in April 2008. The report was in response to the FSF's request to look into the disclosure of high-risk instruments and to those instruments that involved more risk than originally thought.

After the implementation of **International Financial Reporting Standards (IFRS)** we began reviewing its impact on our prudential regime. We had planned to publish a CP early in 2008 but it became clear as the crisis progressed that there were more fundamental issues with existing accounting policies than initially perceived, and that the issues need to be considered in association with the capital adequacy regime. *The Turner Review* and DP recommended significant changes which would introduce countercyclical measures of potential loss into published accounts as well as into regulatory capital. We are now working to achieve agreement and implementation of new approaches through our work within the BCBS, FSF/FSB and in discussions with the International Accounting Standards Board (IASB).

## Credit Rating Agencies (CRAs)

The financial crisis has highlighted concerns about the role of CRAs and potential weaknesses in the credit-rating process. These include concerns about conflicts of interest, methodologies and assumptions used to rate structured financial products, and the potential procyclical impact of excessive investor reliance on credit ratings. *The Turner Review* and DP stressed the need for appropriate regulation of CRAs to address these issues, building on work already in hand, to which the FSA had been contributing at a European and global level.

As a member of the Committee of European Securities Regulators (CESR) task force we responded to a request from the EU Commission to produce a report on the compliance of the largest CRAs in the EU, with the International Organisation of Securities Commissions (IOSCO) **Code of Conduct** for CRAs and on the role of CRAs in rating structured finance products. The report was produced in May 2008.

Working as part of the IOSCO task force, we also contributed to an updated Code of Conduct for CRAs. The new code addresses the issues highlighted by market events concerning the conduct of business of CRAs, particularly with regard to the rating of structured finance products. In response the largest CRAs have updated their own codes of conduct. The IOSCO task force has reviewed these newly updated company codes against its own amended code and the report published in March 2009 is available on the IOSCO website. The IOSCO task force is now developing further work on common supervisory examination models and enhanced coordination/cooperation between supervisors of CRAs.

In June 2008, the European Commission announced it would put forward legislation to implement **a registration scheme for CRAs within Europe**. The Commission then consulted on the topic. Working with the Treasury and the BoE, we published a joint response to the Commission consultation in September 2008.

Following the publication of final proposals for regulation of CRAs in November 2008 we continued to support the Treasury in negotiating the details of the directive which received approval from the European Parliament in April 2009. We are now putting in place the resources and processes to exercise our supervisory responsibilities under the new regulation and continue to provide ongoing input into further CESR and IOSCO work.

## Firms' remuneration policies

Inappropriate remuneration policies, particularly but not exclusively in investment banking and trading, played a role in the origins of the crisis by creating incentives for extreme risk taking. In the past remuneration policies have not been integrated with risk management considerations, and neither the FSA nor supervisors in other countries have focused on remuneration issues. We have already commenced implementation of a radically changed approach, and are working through the FSF/FSB to ensure global standards and effective implementation in all jurisdictions.

In May 2008 Hector Sants raised concerns about risky remuneration approaches in a speech to industry executives. In October we developed and issued an outline Code of Best Practice, and sent a Dear CEO letter to the chief executives of the major UK banks, both domestic and foreign owned, requiring them to review remuneration polices against good practice criteria and if necessary to change them. In March 2009 we published a CP which proposes the incorporation of a Code of Practice on remuneration into the Handbook and to apply it to large banks, building societies and broker dealers. The code has a general requirement that 'a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management'. We have proposed that this should become a Handbook rule.

The CP also invited views on the suggestion that the code should be applied to all other FSA-authorised firms. Although remuneration practices in other financial sectors may not directly have contributed to the crisis, there are other ways in which inappropriate remuneration policies in other firms can be a legitimate cause for concern. For example, poor policies can still increase the risk of material financial loss for firms, and give employees the incentive to promote one product over another, to the potential detriment of customers.

We have also been closely involved in preparing internationally accepted principles on remuneration practices taken forward in two main fora: the Committee of European Banking Supervisors (CEBS) and the FSF. These principles, which are consistent with our own proposals, were published in April and March 2009 respectively. The European Commission has also issued a recommendation on remuneration in the financial services sector and is proposing forthcoming amendments to the CRD. These amendments will include principles on remuneration.

Supervisory authorities in other major centres will therefore be taking steps to incorporate remuneration principles into their own national arrangements. Our CP notes that in order to be effective, policies on remuneration should be implemented globally and consistently. In deciding whether to implement our plans we will take into account whether we think there is satisfactory alignment of implementation plans by authorities in the major financial centres. We will work through the CEBS to seek European-wide implementation and through the FSB to achieve as common international implementation as possible.

## Hedge funds

The role of hedge funds in the financial crisis has been the subject of much debate. *The Turner Review* noted that hedge fund leverage was on average less than sometimes assumed, and concluded that hedge funds had played a non-trivial but not a central role in the crisis of the last two years. *The Turner Review* did, however, recognise that hedge funds in total could exert a procyclical influence, particularly in a period of deleveraging, and that it was possible that individual hedge funds could develop over time, through increases in scale and leverage, to become systemically important. It therefore recommended that financial supervisors should gather data on hedge fund activity to ensure adequate understanding of systemic risks, and that they should have the power to extend appropriate prudential regulation to any hedge funds which did become systemically important/relevant.

This recommended international approach builds on existing FSA practice. The FSA already regulates hedge funds managers as asset managers, and has used its oversight of prime brokers to identify counterpart risks and trends in credit extension and leverage. We will now intensify this supervisory oversight and argue for the imposition of similar systems of hedge fund manager authorisation in those countries where it is not in place.

Detailed legislative proposals on hedge funds are now being developed by the European Union and we provided a joint response with Treasury to the Commission's initial Consultation Paper (published on 18 December 2008).

Last year we highlighted the importance of supervising and **monitoring valuations** by hedge fund managers. Since then, the deteriorating economic environment and illiquidity in certain markets has created some significant challenges in obtaining reliable pricing data. In an environment of poor investment performance, there is an increased risk of pricing errors and intentional mis-marking events and such malpractices are likely to be more readily identifiable. In our discussions with regulated firms we have urged them to mitigate this risk by putting in place independent valuation processes, which include governance and control mechanisms able to detect and/or prevent such mis-marking. Where we have found deficiencies at particular firms we have taken supervisory action. Our focus in this area has contributed to a greater general awareness of industry good practice.

## Risk management in insurance

During the last few years, there has been encouraging progress in the **quality and robustness of insurers' risk management practices**. However, a failure to maintain focus on effective risk management in the current market may lead to policyholders being treated unfairly or to capital erosion. As part of our work to promote market confidence in this area, in September 2008 we set out in an Insurance Sector Briefing our views on some important aspects of insurers' risk and capital management in current market conditions. This included: integrating risk and capital-management practices; the governance, controls and processes in place to respond to sharp changes in market conditions, such as a fall in equities or a counterparty failure; the valuation of illiquid assets, including asset-backed securities; re-thinking and updating stress and scenario practices; and the effect of widening corporate bond spreads on the valuation of liabilities.

## Promoting operational resilience

Promoting operational resilience is a key initiative that contributes to the ability of firms to respond effectively to crises. During 2008 we undertook a re-benchmarking exercise to assess progress made by the industry since the first survey in 2005. The key questions that we asked included: How resilient would the financial sector be to major operational disruption? How quickly would it recover? What needs to be done to improve resilience?

In June 2008 we published a DP focusing on the progress made between the 2005 and 2008 surveys and published feedback to the DP in January 2009. The re-benchmarking reinforced our earlier conclusion that we do not need to be more prescriptive in our approach to business continuity management at this stage. Results show that overall resilience of the sector continues to improve. But by far the greatest cause of concern among respondents continues to be their ability to manage dependency risk, particularly where they rely on third parties to provide essential services.

We launched the Resilience Benchmarking Self Assessment tool in March 2009. It provides firms with a ‘self help’ package to measure and improve their business continuity arrangements. The self-assessment tool is a useful risk-mitigation tool particularly for firms that have not been involved in the previous benchmarking projects. It will help firms evaluate their business continuity arrangements and compare their practice against a benchmark derived from the benchmarking exercise in 2008.

In early November 2008 we decided to re-schedule the Market-wide Exercise to later in 2009. This decision reflected the difficult market conditions at the time and feedback from the industry that in the circumstances they would find it difficult to sustain their level of engagement with the exercise. Our supervisors worked with all retail deposit-taking firms during 2008 to ensure that they had effective plans in place for responding to an increase in retail deposit outflows. At the beginning of April 2009, we initiated a benchmarking survey of those plans in order to assess their overall effectiveness and undertake peer-group analysis.

### Box Two: Short selling

In June 2008, given concerns about the increased potential for market abuse through short selling during rights issues, we introduced requirements for the disclosure of significant short positions in rights issue stocks. In September 2008, as the financial climate continued to deteriorate, we added new provisions to the Code of Market Conduct to ban temporarily the active creation or increase of net short positions in publicly quoted UK financial sector companies. This was accompanied by requirements to disclose significant short positions in such stocks. We believe that taking this decisive action was important to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector.

When we introduced the additional short-selling measures in the Code of Market Conduct we committed to reviewing them after 30 days and publishing the results of a comprehensive review of short selling. After the 30-day review, with one exception, we decided not to make any changes to the measures at the time. Following a consultation in January 2009 on the financial sector stocks measures, we decided to allow the ban to expire but to extend the disclosure requirements until June 2009.

We published a DP on the longer-term regime for short selling in February 2009. We reiterated our views that short selling is normally a legitimate trading activity and that direct constraints were not justified on a permanent basis. However, we proposed that publishing significant individual short positions would improve market transparency and the regulatory regime in this area. This approach would also complement the existing regime for disclosing significant long positions, which has been extended to cover economic interests held by certain derivatives. However, we do not consider that the disclosure thresholds for long and short positions should be symmetrical. Short positions are usually significantly smaller and applying the existing 3% initial thresholds to short disclosures would not provide a meaningful regime. We are also participating actively in international initiatives on short selling and will take account of the outcomes of those exercises in deciding our domestic measures.

## The Banking Act 2009

We worked closely with the other members of the Tripartite Authorities and the Financial Services Compensation Scheme (FSCS) in developing, and consulting on, the Banking Act 2009. This legislation formed a significant milestone in the work of the Tripartite Authorities to strengthen financial stability and depositor protection.

The Banking Act’s powers provide a framework for the orderly resolution of failing banks and building societies, differentiating between the roles of the Tripartite Authorities. The resolution tools themselves comprise a transfer of all or part of the failing firm to a private sector purchaser or to a bridge bank (owned by the BoE), or transfer of the failing bank to temporary public ownership. We are responsible for determining when the powers should be exercised in respect of a failing firm, while responsibility for choosing the particular resolution tool sits with the BoE or, in the case of temporary public ownership, the Treasury. To ensure a coordinated approach, the authority taking these decisions must consult with the other members of the Tripartite Authorities.

In circumstances where it is judged to be the most appropriate solution, the Banking Act provides for a bank insolvency procedure. This procedure obliges the insolvency practitioner to work with the FSCS to ensure fast compensation in relation to eligible deposits. Further provisions allow the FSCS to operate more efficiently. We can collect information on behalf of the FSCS to enable it to perform its functions. In parallel to the changes made under the Banking Act, we have made further changes to compensation arrangements though our rules, including increasing the level of deposit compensation available to claimants.

We are also involved in discussions at European and global level to develop a suitable framework for the resolution of failing banks where there are international implications to be considered.

The Banking Act also introduces the statutory oversight by the BoE of certain systems for payments between financial institutions. We continue to ensure that the necessary operational framework is in place to enable effective action to be taken under the new legislation.

### Box Three: Protecting consumers – compensation reform

In July 2008 the Tripartite Authorities issued a CP that, among other things, described a number of improvements to the FSCS depositor protection arrangements that we, working with the FSCS, planned to progress later in the year.

In October 2008 we increased the general depositor protection limit from £35,000 to £50,000 per person per deposit-taking institution. This means that the vast majority of retail deposits (98% of bank accounts and 97% of building society accounts) are covered.

In order to be fully effective, consumers must understand the FSCS deposit protection arrangements, and these arrangements must be able to deliver compensation soon after the default of a bank or building society. On 6 January 2009, we issued *CP09/3* which set out proposals that would enable the majority of retail depositors to receive compensation within a target of seven days of default. This CP also set out proposals for a strategy to improve consumer understanding and awareness of the FSCS.

Although the £50,000 limit will mean that most retail depositors are fully covered, there are still occasions when customers temporarily have a deposit balance that takes them above this limit. One example is when a customer sells their home, and deposits the money for a short period before buying a new home. To address this issue in March 2009 we published *CP09/11*, setting out proposals for dealing with temporary high balances. There are a number of further pieces of work that we will develop during the coming year, including changes to European legislation that affect our compensation arrangements.

## The Walker Review – reviewing corporate governance of UK banking industry

In February 2009 the Chancellor of the Exchequer, the Secretary of State for Business, Enterprise and Regulatory Reform and the Financial Services Secretary to the Treasury announced a review that aims to recommend measures to improve the corporate governance of UK banks, particularly with regard to risk management. The review is being chaired by the former financial services regulator, Sir David Walker.

The terms of reference for the review are to examine corporate governance in the UK banking industry and make recommendations, including in the following areas:

- the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively;
- the balance of skills, experience and independence required on the boards of UK banking institutions;
- the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees;
- the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and
- whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

We are working closely with Sir David, given the close links between the subject matter of his review and issues of concern to the FSA. Once the review is published, we will consider what changes to our rules and process are required to ensure that problems are addressed.


Land Securities Group
406.25 -7.35
Legal and General Group
41 -10.87
Liberty International
365.5 -15.59
Lloyds Banking Group
64.8 -14.85
Lonmin
1309 -8.4
Marks and Spencer Group
264.5 -0.28

# Promoting efficient, orderly and fair markets

## INTRODUCTION

Much of the work which we carried out in 2008/09 to promote efficient, orderly and fair markets – specifically, our work in response to the global financial crisis – is described in Section One. This includes the actions we took on liquidity, capital, stress testing, credit rating agencies and short selling.

So in this Section, we describe other aspects of our work over the past year focusing on prudential regulation of firms, market regulation and reducing financial crime and market abuse. This has seen us place significant emphasis and attention on ensuring firms adjust to the changing economic environment.

## PRUDENTIAL REGULATION OF FIRMS

Our work relating to the prudential regulation of firms can be usefully organised under three headings:

i. Developments in EU and international policy on prudential regulation;

ii. Developments in domestic policy on prudential regulation;

iii. Specific activities relating to the application of existing policies

### Developments in EU and international policy on prudential regulation

By law we are required to take into account the 'principles of good regulation'. The global scale of the financial crisis has highlighted the importance of the principle relating to the 'international character of financial services and markets'. It has never been more important for us to take into account the international aspects of financial business. As well as the work discussed in Section One, in the past year we were involved in a wide range of EU and international initiatives.

We continued to contribute effectively to the development of the EU's **Solvency II Directive**. The Directive aims to strengthen the prudential regulation of the insurance sector through new regulatory capital requirements and risk-management standards. The new rules will replace the current Solvency I Directive requirements and our existing individual capital adequacy standards (ICAS) for insurers in the UK.

In September 2008 we published a DP setting out some of the expected key changes in UK regulatory requirements and practice, and identified areas in which firms should focus their preparations for the new regime. We were also heavily involved in the work of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). This focused on preparing the technical advice to the European Commission on the Level 2 implementing measures needed to make the new regulatory framework operational. To inform our contribution in CEIOPS and, in particular, so that EU regulation adequately reflects the specificities of the UK market, we have maintained close contact and consulted with the UK industry through the regular meetings of the Insurance Standing Group and its technical sub-groups.

We continue to engage in wider international work on the development of global solvency standards for insurers and insurance groups, through chairing the Solvency and Actuarial Issues Subcommittee of the International Association of Insurance Supervisors.

The European Commission consulted on a wide-ranging package of amendments to the **Capital Requirements Directive (CRD)**, including large exposures, hybrid capital and securitisations. We contributed to the technical advice to the Commission provided by the CEBS, and supported the Treasury in the Commission-led CRD working group and in representing the UK in European Council negotiations.

A key outcome from this work was a more balanced, proportionate set of amendments agreed in the Council – for example, relief for smaller institutions in the limit that is likely to apply to large inter-bank exposures. Most of the CRD amendments were subject to the European co-decision process. The final compromise text is due to be published in 2009 once agreement is reached between Council and European Parliament.

In 2007 the European Parliament and the European Council (EC) adopted the Acquisitions Directive, which concerns procedural rules and evaluation criteria for the **prudential assessment of acquisitions** and increases of holdings in the financial sector. In September 2008 we published a joint CP with the Treasury setting out how we propose to implement the Directive using an effective, proportionate, and risk-based approach. We aim to develop a regime that takes into account the scope of the Directive and the level of harmonisation required; the notification and decision-making process; and the deadlines for assessment and prudential criteria.

The Directive was transposed into FSMA in March 2009. We made corresponding changes to our Handbook requirements and published them in March 2009. A number of new criminal offences have also been introduced into FSMA; for example, a controller who fails to notify us that they have taken a percentage control of an FSA-authorised firm may now be sentenced on indictment to an unlimited fine; previously the level was capped at £5,000.

In 2008 the European Commission published its long-awaited package of structural reforms to the **Undertakings for Collective Investments in Transferable Securities (UCITS)** Directive (known as UCITS IV). UCITS schemes are a pan-European retail investment product. Working with the Treasury, we contributed to the negotiations on the draft recast Directive. We were able to achieve drafting that reflected UK policies; in particular the original Commission proposals omitted the 'management company passport' (MCP) but this was inserted during the Council negotiations. The Directive should be formally adopted in 2009.

## Developments in domestic policy on prudential regulation

In 2008/09 we published a CP and subsequent Policy Statement outlining our proposals for modifying the Client Assets Sourcebook (CASS). Our key policy aim in CP08/6 was to simplify the structure of our rules, increase the flexibility available to firms by moving to more outcomes-focused regulation and, where possible, provide a common platform for firms, based on the Markets in Financial Instruments Directive (MiFID) standards.

We completed our review of CASS with the release of an updated sourcebook in January 2009. The result is a more streamlined and easier-to-use sourcebook, which was widely welcomed by industry. We have deleted rules and guidance where justified by cost-benefit analysis and simplified the wording in CASS by adopting a plain English style.

Following the insolvency of Lehman Brothers International (Europe) we provided regulatory guidance on CASS to the joint administrators. In addition, we reviewed client asset and money systems and controls in a significant number of firms, subsequently issuing a Dear Compliance Officer letter, detailing how we expect firms to comply with our client asset requirements.

During 2008/09 we worked to improve the prudential requirements for **personal investment firms (PIFs)** and to help reduce the impact of market failures in the sector. In November we published a CP introducing a revised set of standards for firms. Our reforms, which will mean PIFs holding more capital resources where necessary, are designed to mitigate the impact of such firms on the FSCS and to reduce the complexity of the capital resources rules.

The proposed new regime, which builds on earlier work, includes:

- simplifying the calculation of capital resources and making it consistent for all firms;
- extending the Expenditure Based Requirement to all firms, based on three months of annual fixed expenditure and raising the minimum capital resources level from £10,000 to £20,000; and
- mandating a sliding scale of additional capital resources, which firms should hold as a provision against potential liabilities for any business or activity excluded from their professional indemnity insurance policies.

The prudential proposals are closely linked to issues covered in the FS to the Retail Distribution Review (RDR) discussed in Section Three.

In July 2008 we completed our thematic review of the **Management of Conflicts of Interest in Private Equity Firms** and published our findings in our July 2008 *Capital Markets Bulletin*. The key objectives were to inform ourselves and wider industry stakeholders of the prevailing standards for conflict of interest identification and management in the private equity industry, to promote good practice and to raise awareness of areas for improvement within both the market and regulatory community.

Most of the firms we reviewed appeared to operate business models demonstrating a high degree of alignment of interests between the firm and its fund investors. However, we noted the need for firms to ensure they develop sufficiently formalised internal polices/procedures to identify and mitigate those areas where conflicts may, or are likely to, occur. These findings are being developed with individual firms and through broader engagement at relevant industry seminars.

**Box Four: Soundly managed firms – taking action**

On 13 August 2008, we fined the UK operations of Credit Suisse (the subsidiaries) £5.6m for breaching Principles 2 (management and control) and 3 (due skill, care and diligence) of our Principles for Business. Credit Suisse announced its financial results for 2007 on 12 February 2008. On 19 February 2008, Credit Suisse announced that it had identified mis-marking and pricing errors by a small number of traders and that it was re-pricing certain asset-backed securities. The re-pricing involved a write down of revenues by US$2.65 billion. The subsidiaries had failed to take appropriate steps to control the potentially high-risk combination in the Structured Credit Group's holdings of exotic products, opaque valuations and high leverage. The sudden and unexpected announcement of the write down had the potential to undermine market confidence.

In the insurance sector, during 2008/09 we continued our work to assess how firms apply controls to their **underwriting strategy**. We reviewed how individual insurers set their risk appetite and underwriting strategies, and the systems they have in place for monitoring their performance against their strategy. These assessments will continue to be a core theme in our supervision.

We also maintained our focus on addressing risks related to **wholesale insurance intermediaries**. A key part of this was the work conducted with the General Insurance Market trade bodies to develop industry guidance relating to transparency, conflicts of interest and disclosure. We also published a paper explaining how we view credit write-backs and our expectations of how firms should deal with this in line with our Client Asset rules, relevant trust law and Generally Accepted Accounting Principles (GAAP). Firms that handle client money need to take reasonable care to establish and maintain effective systems and controls for compliance with our client money requirements.

## MARKET REGULATION

Activity this year has focused on: actions to address risks in over the counter (OTC) derivative markets; a wide range of initiatives relating to the equity markets; and initiatives relating to covered bond markets, Islamic finance and emissions trading.

In late 2005 we took joint international regulatory action to monitor and reduce **derivative trade** confirmation backlogs among large dealer firms. Since work began in this area we have achieved:

- 92% backlog reduction in credit derivatives (despite volume increases of over 300% since 2005);
- 74% confirmation backlog reductions in equity derivatives since 2006; and
- 53% confirmation backlog reductions in interest rate derivatives since 2006.

During 2008/09 we took steps to address our concerns about the increased volume of trading in derivatives. We ensured that firms set themselves targets for reducing and automating outstanding OTC derivative classes, including credit, rates, foreign exchange, equity and commodities, and we requested reporting on collateral management for the first time.

In addition, the industry has embraced automation and electronic platforms and is moving towards central-clearing counterparties for credit derivatives, which will reduce counterparty credit risk and improve transparency of the market. We have continued to monitor firms' performance against increasingly tough backlog reduction and automation targets.

There has been a significant amount of change in international capital markets in recent years. In response to this we published a DP on whether any changes should be made to the structure of the **UK Listing Regime** to ensure that it retains sufficient clarity for market participants while maintaining the competitiveness of the UK markets.

We published CP08/21 in November 2008 proposing changes to the Listing Regime to:

- improve the clarity of the UK Listing Regime's different segments;
- enhance disclosure requirements on corporate governance for overseas companies; and

- provide a level playing field for UK companies in terms of their listing options.

Last year we completed our work on reviewing the **sponsor regime.** In March 2008, we published a CP asking for market participants' views on our proposed changes to the regime. The proposals set were designed to help us achieve our long-term objective of more outcomes-focused regulation.

In July 2008, we published CP08/12. This proposed two additional amendments to the sponsor regime, relating to sponsor independence and the provision of information to us. The new Listing Rules for sponsor firms deliver, in a more outcomes-focused manner than the old rules, a more practical regime that reflects good market practice. This work has contributed to a key UK Listing Authority (UKLA) objective of providing an appropriate level of protection for investors in listed securities.

Following the publication of the **Rights Issue Review Group** report to the Chancellor in November 2008, we were commissioned to consult on reducing the rights issue subscription period from 21 to 14 days (or ten business days) as a means of facilitating the raising of new capital by issuers. We published CP09/4 on shortening the rights issue subscription period and made the changes to the Listing Rules to provide for a period of at least ten business days, effective from 9 February 2009. The shortened period allows issuers to raise capital more quickly and effectively – which is an important factor in maintaining market confidence and international competitiveness in this area.

## Box Five: Market monitoring – taking action

Clear, efficient and orderly markets depend on timely and proper disclosure of relevant information. Investors deserve this, and we expect firms to meet our high standards. Where these standards are not adhered to, we have taken tough enforcement action. Last year, we fined three firms a total of £735,000 for listings breaches. Woolworths Group plc were fined £350,000, Wolfson Microelectronics Plc £140,000 and Entertainment Rights plc were fined £245,000 for failing to disclose price sensitive information to the market in a timely manner.

We have carried out significant work over the last two years to address issues raised by the use of **Contracts for Difference (CfDs)**, which to date have not been within the scope of the UK's disclosure rules. This has led to situations where CfDs have been used on an undisclosed basis to build stakes in companies or to exert influence over corporate governance.

Following consultation, we made new rules requiring aggregation of CfDs and similar instruments with shares and other currently disclosable instruments, so that disclosures of all such instruments are made when they exceed the threshold of 3% of a company's shares. This helps to improve market confidence, as CfDs cannot now be used on an undisclosed basis to circumvent the intended benefit of the Disclosure Rules. The regime, which applies to UK incorporated issuers only, comes into effect in June 2009.

In March 2008 the UK **Regulated Covered Bond Legislation** came into effect, implementing Article 22(4) of the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive, Article 22(4) of the Third Non-Life Directive and Article 24(4) of the Consolidated Life Directive.

After a detailed review of initial applications we added the first seven issuers to the UK Regulated Covered Bonds Register (available on our website) in November 2008. Investors with an exposure to covered bonds that meet the necessary requirements may benefit from a preferential regulatory capital requirement reduction in risk weight of up to 60%. This is designed to bring the UK-covered bond market onto a level playing field with other European jurisdictions. We believe this will provide investors with greater confidence in the market. Regulated covered bond issuers and programmes are now subject to continuous supervision.

During the past year we continued to make progress on developing an appropriate regulatory framework for **Islamic finance** in the UK. Working with the Treasury we published a joint CP in December 2008 proposing a new legislative framework for the regulation of Sukuk (alternative finance investment bonds) in the UK. This initiative is important in ensuring that legislation is designed in a way that creates a level playing field between conventional and Islamic debt instruments. Alongside this work we chaired an IOSCO working group that produced a report on the compatibility of the IOSCO principles with the principles and practices of Islamic finance. The report highlighted potential risks facing the industry and indicated that there were no substantive conflicts between the IOSCO principles and Islamic finance.

To understand what risks, if any, were emerging from the rapidly growing **emissions trading markets** we undertook a series of discussions with several investment banks, infrastructure providers, price reporters and specialist carbon market participants. Using this information and our own research we published a paper in March 2008 that identified areas of potential risk. Key issues included the lack of pricing history, availability of information, market abuse and market liquidity.

As outlined in the paper, financial emissions derivatives market activity falls within our regulatory remit. However, we do not have any specific responsibilities regarding emissions trading. Our responsibilities are the same as they are for other commodities derivatives markets. We believe that this work has improved stakeholders' understanding of potential risks in this emerging market. We will continue our market supervision of this area and communicate any new risks as they develop.

## REDUCING FINANCIAL CRIME AND MARKET ABUSE

One of our statutory objectives is to reduce the extent to which it is possible for a financial services business to be used for financial crime. During 2008/09, we demonstrated that we are willing to take on tough challenges – we used all our civil, criminal and administrative powers to deliver on our obligations where we have had the lead responsibility. Our focus is on delivering credible deterrence under our obligations in the FSMA. We took action in relation to market-related offences (issuing our first ever criminal conviction for insider dealing, see Box Six) and issues relating to unauthorised activities such as share sale frauds (sometimes known as boiler rooms).

We are not, and do not seek to be, the responsible agency for prosecuting financial fraud in its conventional or wider sense. This responsibility is shared elsewhere: for example, by law enforcement and other prosecutors. When we suspect financial crimes in our regulated community, and where we cannot take direct action to prosecute offenders, we will exclude perpetrators from the regulated community and progress our credible deterrence agenda through our partners, by providing intelligence and facilitating the flow of information.

### Market abuse

In June 2008 we published our overall anti-market-abuse strategy. A key component of our financial crime objectives and our credible deterrence strategy is our work to tackle market abuse. We secured an increase in the number of enforcement outcomes with nine market-abuse penalties announced and commenced three new criminal prosecutions for insider dealing. In March 2009, our first criminal insider dealing case resulted in guilty verdicts and eight-month custodial sentences for both defendants. As outlined in Section One, we took action to prevent potential abuse and disorderly markets arising from short selling in certain market sectors and published proposals for the longer-term regime.

We maintained our focus on working with industry to strengthen anti-market-abuse systems and controls. We placed particular emphasis on controls for dealing with inside information on mergers and acquisitions by regulated and non-regulated firms. We wrote to more than 60 FSA-regulated firms, including the major corporate finance advisory firms, to initiate system and control reviews and make improvements where necessary. In June an industry working group we sponsored published a set of principles of good practice to help non-regulated firms review their mergers and acquisitions systems and controls. These actions support our stated intention of taking a tougher stance on market abuse to achieve a credible deterrence and taking action where appropriate, while at the same time continuing to promote steps to prevent abuse occurring.

We have made good progress on implementing the Sabre II programme. Work during 2008 focused on putting in place the functionality needed to enhance our detection and pursuit of market abuse and to process securities derivative transaction reports using the Alternative Instrument Identifier, which we need to finish implementing our MiFID obligations.

### Market cleanliness statistics

As part of our market monitoring activity, we analyse the scale of share prices 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.

It can be easy to misinterpret what the market cleanliness statistics show, especially with regard to share price movements ahead of takeover announcements. It is important to realise that the level of 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, non abusive trades that just happen to fall before an announcement. In some circumstances there may also be a deliberate 'strategic' leak of information to help position an important deal in the marketplace. This is clearly improper but it may not actually give rise to any opportunity for insider dealing. 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.

It is also important to note that due to the statistical thresholds used when computing abnormal pre-announcement price movements (APPMs), even if there is no insider or other abnormal trading, we would not expect the results to be zero but, on average, 10% for the takeovers data set and 3% for the set of other significant trading announcements made by FTSE 350 firms. For reasons of statistical significance, a movement of about 5% in either direction is needed before it is safe to conclude that the level of informed trading has changed from one period to the next. Finally, extreme volatility of share prices, as we saw during 2008, may also affect the results. The full methodology and analysis is in our March 2007 Occasional Paper and April 2008 Market Watch on our website.

For the reasons set out above the statistics are only one of many factors that we consider when setting our anti-market abuse strategy.

The level of APPMs for 2008 is similar to 2007. We remain committed to achieving a reduction in all types of market abuse through continuing to pursue our proactive market abuse strategy. We expect that our current strategy will achieve credible deterrence in the markets.

**Table 2.1: The measure of market cleanliness for the takeovers analysis**

| Year | Announcements | APPMs | Percentage (APPMs/Announcements) |
|---|---|---|---|
| 2000 | 183 | 44 | 24.0% |
| 2002 | 147 | 37 | 25.1% |
| 2003 | 160 | 22 | 13.8% |
| 2004 | 102 | 33 | 32.4% |
| 2005 | 177 | 42 | 23.7% |
| 2006 | 199 | 57 | 28.6% |
| 2007 | 167 | 48 | 28.7% |
| 2008 | 181 | 53 | 29.3% |

**Table 2.2: The measure of market cleanliness for the FTSE 350 analysis**

| Years | Announcements | Significant Announcements | APPMs | Percentage (APPMs/Significant Announcements) |
|---|---|---|---|---|
| 1998/1999/2000 | 487 | 51 | 10 | 19.6% |
| 2002/2003 | 734 | 54 | 6 | 11.1% |
| 2004/2005 | 927 | 49 | 1 | 2.0% |
| 2006/2007 | 1,085 | 78 | 6 | 7.7% |
| 2008 | 428 | 50 | 5* | 10.0% |

*In calculating the number of APPMs for the FTSE 350 analysis we cleansed the data by stripping-out two positive company announcements that were preceded by downward share price movements. This is because it is clear that both share price falls were attributable to wider market declines at that time and not to the announcements which were positive news stories.

**Box Six: Tackling market abuse – criminal prosecutions and civil penalties**

- In March 2009, Mr Christopher McQuoid, a solicitor, and his father-in-law, Mr James William Melbourne were found guilty of insider-dealing. The jury found that Mr McQuoid had passed inside information to his father-in-law and that Mr Melbourne had traded, and made a profit using the information. This was the first insider dealing criminal prosecution brought by the FSA, as part of our tougher approach to tackling market abuse.

- In addition to the McQuoid/Melbourne prosecution, we began two other insider-dealing prosecutions and conducted two major search and arrest operations in 2009.

- Also in March 2009, we won the market abuse case at the Tribunal against Winterflood and two of its traders, Mr Sotiriou and Mr Robins. Winterflood is an FSA-authorised firm and the largest market maker in AIM securities. In June 2008, we found that Winterflood and its traders had played a pivotal role in an illegal share ramping scheme relating to Fundamental-E Investments Plc (FEI), an AIM-listed company. In particular, the market maker had misused rollovers and delayed rollovers, thereby creating a distortion in the market for FEI shares and misleading the market for about six months in 2004. Winterflood disagreed with our findings and referred the matter to the tribunal, who upheld our decision. As a result we imposed fines of £4m, £200,000 and £50,000 on Winterflood, Mr Sotiriou and Mr Robins respectively.

- In addition to the Winterflood outcome, we imposed financial penalties totalling £675,000 on eight individuals and one firm for market abuse.

In October 2008 we published our thematic work findings following visits to a cross section of hedge fund managers (HFMs) in order to ascertain the extent and appropriateness of market conduct controls within the sector. The firms participating in the thematic work all appeared to have given reasonable consideration to market abuse issues. We found examples of good practice, as well as scope for improvement in some areas. Given the range of strategies and investment styles employed by HFMs and the varying governance and reporting structures within those firms, we expect variances in their market abuse control procedures. We will incorporate our findings in our supervisory visits to HFMs, assessing industry progress through future risk assessments of individual firms.

## Financial crime

We require every firm to establish and maintain effective systems and controls to counter the risk of financial crime, including bribery and corruption associated with making payments to third parties. As part of our thematic work in this area, which started in Q4 2008, we are assessing the adequacy of firms' systems and controls for the prevention of illicit payments and inducements.

We also require participants in the financial services industry to have integrity. We have continued to work towards achieving our financial crime objective by keeping persons of doubtful integrity out of UK financial services by closely scrutinising applications from individuals and firms at the approval and authorisation stages of the application process.

**Box Seven: Financial crime – credible deterrence**

On 8 January 2009, we fined Aon Limited (Aon) £5.25m for breaches of Principle 3 of our Principles for Business (management and control). We found that they failed to take reasonable care to establish and maintain effective systems and controls to counter the risks of bribery and corruption associated with making payments to overseas firms and individuals. As a result of Aon's weak control environment, the firm made various suspicious payments, amounting to approximately US$7m, to a number of overseas firms and individuals.

To gain a better understanding of the level and type of financial crime risks within particular industry sectors, we completed a number of thematic reviews during the year. One of these focused on assessing firms' data security controls to prevent loss or theft of consumers' personal data by employees or third-party suppliers. We published our findings in April 2008, and provided informal guidance for firms to help them to implement more effective controls.

Other examples of our thematic work this year include the review of firms' governance and controls over key offshore functions; we published a factsheet summarising the findings of this work in April 2009. We also started work on our small firms review – initiated as a result of feedback from the Financial Action Task-Force (FATF) Mutual Evaluation of the UK's anti-money laundering and terrorist financing regime. Once completed, this work will allow us to establish a baseline, against which we can assess, in a statistically valid way, the effectiveness of UK small firms' anti-financial crime systems and controls.

As required under the Money Laundering Regulations 2007, we began monitoring the anti-money laundering controls of businesses such as leasing companies and commercial finance companies, including forfeiting and safe custody service providers. Responding to the risk that the safe custody sector posed the highest financial crime risk within the sector, we began work on developing industry-led guidelines. We also hosted a conference for safe custody providers to raise awareness of the key financial crime risks affecting the sector.

We also continue to work closely with our European counterparts in developing a proportionate approach to tackling financial crime in the development of international policy. During 2008 we increased our participation and leadership in the FATF and continued to work with other international organisations. Our work has helped to promote a common interpretation of European anti-money laundering and counter terrorist financing legislation and assisted in the adoption of proportionate approaches to financial crime prevention across Europe.

Responding to indicators suggesting that lenders were falling victim to consumer and organised mortgage fraud, we re-launched the 2006 Information From Lenders (IFL) scheme. The scheme is run in collaboration with the Council for Mortgage Lenders (CML) and aims to improve the sharing of information to reduce the risk of financial crime occurring. As a result of this work, we intensified our supervision of many firms – some of these have been prohibited or received heavy fines, while others have left the industry altogether.

We worked closely with relevant trade bodies to encourage market-led initiatives, while continuing to supervise both brokers and lenders to ensure that the industry is actively raising its defences against mortgage fraud. In August 2008, we published information about our work on fraud, directed at smaller mortgage brokers. This included an 'aide memoire' aimed at helping smaller brokers to understand what fraud looks like and how it can affect them. This project also increased engagement with lenders and we developed procedures to ensure consistency of our approach in dealing with firms.

As demonstrated by the outcome of our work with the CML and law enforcement, we are aware that effective collaboration between stakeholders is essential in fighting financial crime. Throughout the year we have strengthened our relationships with our financial crime stakeholders, such as law enforcement, firms and government bodies. An example of this was the arrest of 11 people by the City of London Police on suspicion of mortgage fraud. We worked closely with police forces to ensure that regulatory and criminal action was pursued where possible. We also developed a close working relationship with the newly formed National Fraud Strategic Authority (established October 2008) and are collaborating with them to help develop their financial crime consumer awareness strategy.

### Box Eight: Mortgage fraud – taking action

Cracking down on mortgage fraud is an important strand of delivering our credible deterrence strategy. Mortgage lenders provide us with intelligence on suspect brokers and we use our powers to investigate and take strong enforcement action. During the year, we prohibited 23 individuals and imposed three financial penalties of over £100,000 each on brokers who were knowingly concerned in mortgage fraud. We also imposed penalties on firms that had failed to establish and maintain effective systems and controls to counter the risk they could be used for mortgage fraud.

← Heron Quays DLR
Canary Wharf DLR →

# Helping retail consumers achieve a fair deal

## INTRODUCTION

In the continuing financial crisis our objective of securing the appropriate degree of protection for consumers has never been more important. We tackle this objective through our work on conduct regulation, which focuses on: identifying risks in the way firms deal with their customers before the risks crystallise; working with firms to identify, assess and mitigate retail conduct risks in a timely way and to ensure fair consumer outcomes; and taking prompt and decisive action in response to crystallised risks so that consumers receive fair redress promptly and firms are held to account for poor practices.

We are very conscious that the past year has been very tough for many consumers. Along with our strong focus on conduct risk we continued to:

- drive forward work on consumer education, enabling consumers to engage proactively and responsibly with financial matters;
- act to prevent and deter regulated firms and other market participants from engaging in or facilitating financial crime;
- take tough enforcement action against firms and individuals that fail to treat their customers fairly; and
- apply a risk and more outcomes-based regulatory approach and regime, intervening proactively and proportionately to deliver credible deterrence and redress.

## ENSURING FIRMS ARE DELIVERING FAIR OUTCOMES FOR CONSUMERS – TREATING CUSTOMERS FAIRLY (TCF)

The TCF initiative was introduced to address long-term issues in the retail market in an enduring way, so that consumers could be confident of receiving fair treatment and firms could demonstrate they are meeting their regulatory obligations.

### Monitoring industry progress in delivering TCF

We gave firms an interim deadline of March 2008 to have appropriate management information (MI) or measures in place to test whether they are treating their customers fairly. In June 2008 we published the results of our sample assessments of progress made against the deadline. Of the relationship-managed firms that failed to meet the deadline, we saw a very broad spectrum of results: from those firms that had invested significant time and energy and so almost met the deadline, through to firms we considered for investigation and enforcement action on grounds of potential or actual consumer detriment.

To realise the benefits of the TCF initiative more quickly, in November 2008 we decided to move TCF assessments into our core supervisory work earlier than originally planned – from January 2009 all ARROW assessments with a retail component will include a TCF assessment, which includes:

- a review of TCF outcomes: direct testing of the customer outcomes, with reference to a firm's own MI (where we believe it is robust), other relevant intelligence about the firm's conduct; and
- an assessment of the firm's culture to understand potential reasons where there is poor performance or identify where good performance might not be maintained.

### Dealing with failures to treat customers fairly

Where we found failings in firms' treatment of their customers, we continued to use our full range of regulatory powers to take tough action. More details on our enforcement activities in this area can be found in Appendix Five – included in this section are a number of examples where we have taken action against firms.

## Systems and controls

In September 2008 we fined GE Money Home Lending (GE Money) for breaches of Principle 2 (skill, care and diligence) and Principle 3 (management and control) of our Principles for Businesses. We found that the firm's systems and controls failings resulted in 684 borrowers suffering financial loss in excess of £2.3m before redress was later paid by the firm.

In May 2008, we fined UNAT Direct Insurance Management Limited (UNAT) £640,000 for failings relating to a lack of effective control and oversight over its appointment of call centres. UNAT sold general insurance products to customers through call centres, but failed to carry out proper checks on the call centres it used. UNAT's failure exposed customers to an unacceptable level of risk that they would not be treated fairly.

On 28 July 2008, we fined Hastings Insurance Services Ltd (Hastings) £735,000 for failing to treat its customers fairly in relation to cancelling around 4,550 incorrectly priced car insurance policies. Hastings discovered that, due to an internal system error, inaccurate insurance quotations were given to customers, which resulted in some of them paying lower premiums than they should have. Hastings cancelled the policies but in doing so failed to give sufficient consideration to paying the premium shortfall to the insurance provider or investigating other possible remedies. We found that the firm had put its own interests ahead of its customers and failed to meet our requirement to embed the TCF principle into its corporate culture.

## Firms' communications with consumers

In 2008/09 we continued our work to improve the quality of point-of-sale disclosure for investment products. After publishing the results of our review of Key Features Documents in 2007, we implemented the action plan set out in that document by working with firms and trade associations to improve the quality of disclosure. In the first quarter of 2009 we reassessed a sample of documents based on those that performed worst in our original review. Over two-thirds of those showed significant improvements. Those not achieving the improvements we required were largely produced by asset managers. We will maintain our focus on the quality of disclosure in 2009/10 through our regular supervision activities. We will also take appropriate action to follow up with those firms that have not achieved the standards we expect.

## Projection requirements

As part of our post-implementation review work of Conduct of Business Sourcebook (COBS) we committed to assess the use of **projection information** under both the MiFID and non-MiFID requirements. We carried out a piece of thematic work assessing the standard of projections information and in particular whether appropriate rates are being used. This work highlighted some concerns about firms not using lower rates where it would be appropriate to do so e.g. projections for cash funds. We reminded firms in a Dear CEO letter of their obligations under our rules and of the need to consider the information needs of consumers who may have relied on projections at the point of sale.

On 9 April 2008, we fined Liberata Financial Services Ltd £525,000 for breaches of Principles 2 (management and control) and 3 (due skill care and diligence) of our Principles for Business. The failings resulted in 30,000 policyholders not receiving information, with 161 suffering financial loss amounting to £17,584. The failings were particularly serious because they put policyholders at risk of not receiving important information about their savings and pensions products. Customers were clearly not being treated fairly.

During 2008/09 we imposed financial penalties totalling £9.5m on 20 firms for systems and controls failings that may have put customers at risk of not receiving suitable advice. This included a fine of £900,000, imposed on Thinc Group in May 2008, for failing to have adequate risk management systems for its subprime mortgage business and for failing to ensure it had records to prove advice had been suitable.

We designed and implemented new techniques to enhance our identification of **prudential issues and inaccurate financial returns in small firms** and used these techniques in analysing information submitted by 7,000 small firms. We followed this up by visiting firms where we identified problems and provided support to improve their understanding of common reporting mistakes. We believe that this work will improve small firms' delivery of financial returns in the future, their understanding of the issues in this area and help us to get more reliable financial information from them. Reliable and prompt returns represent an essential element in our monitoring of all firms, especially those which do not have a dedicated supervision team.

## Box Nine: Our enhanced strategy for small firms

Throughout 2008/09 we continued to pursue our enhanced strategy for the supervision of small firms. This focuses on increased supervision of and contact with small firms, and combines support for those embracing TCF outcomes with a tough approach for those who are not.

During the year we:

- delivered interactive roadshows to firms in regions due to be assessed to help them understand what is expected of them – we received positive feedback on the roadshows from firms confirming that these have helped them improve their understanding of TCF;
- completed the assessments of some 2,000 firms from the first four regional programmes (Northern Ireland, North West, West Midlands, South West) – firms have said that the assessment has heightened their awareness of TCF and what it should mean for them; and
- carried out follow-up visits to all firms assessed as being at high-risk of not treating customers fairly, and verification visits to a sample of other firms to test the accuracy of the assessment process.

We will continue to take against those firms who are assessed as high risk and who are not embracing the TCF outcomes and are unwilling to change. We have applied the techniques used in the communication and assessment process to other areas of our work such as Pensions Switching.

## Box Ten: Payment protection insurance (PPI) – taking action

There are around 20 million PPI policies in force, with around seven million new policies sold annually. During 2007, consumers paid around £4.2 billion in premiums. The large number of consumers active in the market, coupled with the high risk of consumer detriment, are the key reasons we took such a keen interest in the PPI market when we became responsible for the regulation of the insurance selling on 14 January 2005. The aim of our work on PPI is to secure better outcomes for consumers through ensuring firms improve their sales standards, limiting consumer detriment from inappropriate sales and helping consumers make well-informed purchasing decisions.

During the year we took disciplinary action against ten firms. This included the largest fine in the retail sector of £7m against Alliance & Leicester for serious failings in its PPI telephone sales. Our strong commitment to achieving real credible deterrence saw us increase the level of fines for firms that do not improve their sales practices.

In September 2008, we published findings from the mystery shopping that captured face-to-face branch sales of single premium PPI sold alongside unsecured personal loans. In light of ongoing concerns over sale standards, we escalated our regulatory intervention and have been identifying and remedying non-compliant sales. In January, we welcomed the move by major market participants to switch from single to regular premium PPI products. Due to our continuing concerns over the standard of sales, in February this year we published a Dear CEO letter addressed to all firms still selling single premium PPI requesting that they stop. As a result of this action no major firms will sell or underwrite single premium unsecured personal loan PPI from 29 May 2009.

In July 2008, the Financial Ombudsman Service (FOS) wrote to us invoking the 'wider implications' process regarding past PPI sales because of the large number of PPI complaints it was receiving. We have met regularly with the FOS to discuss its concerns and have kept it up-to-date with our regulatory response to problems in the market. We published a written interim response to the 'wider implications' referral in April. The letter outlined some of the action we had undertaken and also set out our plan to consult on Handbook guidance on firms' handling of PPI complaints in 2009.

To help improve consumers' knowledge of the PPI market we published comparative tables on our *Moneymadeclear* consumer website so they can easily assess the wide range of policies available. Since they were launched in June 2008, over 16,000 consumers have used the tables. We conducted research with some users of the PPI tables and found the majority of people were likely to revisit them and recommend the service to others.

In December 2008 we published the findings of our thematic review of **pension switching advice.** We found some firms consistently providing suitable advice, but we were concerned that many were not. In response we announced a programme of action. We have ensured remedial action has been taken where firms had given unsuitable advice, including firms paying redress where customers have suffered financial loss. In addition, we wrote to over 4,500 firms asking them to consider the approach that they have taken on past sales and, if necessary, look at a sample of files to assess whether they meet our standards. Where firms identified issues, we expected them to take appropriate remedial action.

To provide practical help and guidance on improving standards and to clarify our expectations, we organised roadshows across the UK for 1,500 small firms early in 2009. In February 2009 we published a pension switching suitability assessment template on our website. Firms can use this as a resource to enhance and challenge their existing compliance monitoring processes.

As part of our broader work on pensions and TCF, in November 2008 we fined AWD Chase De Vere Wealth Management Ltd (AWD) £1.12m for serious failings in its pension transfer, pension annuity and income withdrawal business that resulted in mis-selling. We found that AWD failed to establish its customers' needs and did not provide them with complete and accurate information, which resulted in a large number of mis-sales. In addition to the financial penalty, the firm reviewed past business and agreed to compensate customers where appropriate.

## Box Eleven: Improving the market for investment products and services – the Retail Distribution Review (RDR)

In 2008/09 we continued our work on the RDR – one of the core strands of our retail market strategy that complements our aims to improve financial capability and further ensures firms deliver fair outcomes for consumers. It is essential for promoting a resilient, effective and attractive retail investment market. The difficult economic environment presents a number of challenges to the RDR and we are taking these into account in designing the policy.

In April 2008, we published the RDR Interim Report and in November 2008, we published an FS outlining our high-level RDR proposals.

These proposals aim to bring important changes to the retail investment market and seek to improve consumer confidence in this market. They involve raising the standards that consumers can expect from all firms giving investment advice – both by increasing professional requirements and by tackling the potential for commission to bias advice. They also involve proposals to provide greater clarity for consumers about the advice being offered.

The key proposals in the FS included:

- Adviser charging – adviser firms will be required to set their own charges and product providers will not be allowed to set remuneration terms. This will bring to an end the current practice of product providers offering adviser firms amounts of commission for selling their products. This is an important change, to support both improved consumer trust and confidence and overall industry sustainability.
- Clarity of services – distinguishing between independent advice and non-independent advice to provide improved clarity for consumers about the advice services available. The key points of this distinction are:
  - o Independent advice is where adviser firms are equipped to give a comprehensive and fair analysis of their relevant market and provide recommendations that are unrestricted and unbiased.
  - o Non-independent advice is where firms recommend the products of one or a limited range of providers. Advisers in this sector will need to make this clear to customers, while also showing clearly the cost of their advice.
- Higher standards of professionalism that inspire consumer confidence and build trust. We are doing this in three ways:
  - o by improving the quality of advice being given to clients by raising minimum levels of competence, skills and knowledge;
  - o by improving the perception of the sector by establishing and enforcing common ethical and behavioural standards; and
  - o supporting these and the wider RDR proposals and mitigating the potential risks from them, by implementing an agreed, visible and effective common framework for professional standards to govern standards of practice.

We will publish a CP on the detailed policy proposals for the RDR in June 2009, followed by a Policy Statement in 2010, with the intention that all firms will have implemented the changes by the end of 2012.

In response to recommendations made by the Treasury Select Committee in October 2008, we started work on reviewing how our **with-profits regime** is operating in practice. Our work on the review so far has focused on supervisory areas of concern and as we progress with the review, we will consider whether aspects of the rules need amendment or clarification.

During the year we responded to concerns that the rule allowing proprietary firms to charge mis-selling compensation costs to their with-profits funds may lead to policyholders being treated unfairly. In February 2009 we published a CP following responses we received to CP08/11. The CP set out our proposals that proprietary life assurance firms should not in the future be permitted to charge the cost of payments of compensation and redress to their with-profits funds. We believe that the proposed changes are important to ensure that with-profits policyholders are treated fairly.

In response to reports that some **mortgage lenders were failing to treat their customers fairly** when pursing outstanding debts we reviewed the arrears-management policy and practices of a sample of mortgage lenders. In our findings, published in August 2008, we noted that mainstream lenders were largely complying with our requirements, but there were particular concerns with specialist lenders, who tended to operate a 'one size fits all' approach that did not take individual borrowers' circumstances into account. To help firms assess and improve their arrears-handling practices, we published examples of good and poor practice.

In November we also sent a Dear CEO letter to mortgage lenders and administrators asking their senior management to review current arrears policy and to address any weaknesses as a matter of urgency. We have been following up specific issues with individual lenders, including through enforcement action in some cases. Our regular assessments of mortgage lenders and administrators now include consideration of their treatment of customers in arrears. We have also supported the Civil Justice Council in introducing a pre-action protocol for mortgage possession claims, based on our mortgage regime. The protocol came into force in November 2008.

Last year we began work on the **Mortgage Market Review**. This will enable us to develop a view on the future shape of this market and how our approach to regulation should evolve to reflect this. The review covers the complete value-chain in the market (e.g. lenders, intermediaries and consumers) and all aspects of regulation, including prudential, conduct of business, and financial crime. We are also considering whether any read-across to the mortgage market is appropriate from the proposals made by the Retail Distribution Review (RDR) in relation to the investment market. As announced in *The Turner Review* we will publish a DP on the Mortgage Market Review in September 2009.

During 2008/09 we undertook follow-up work to the first Quality of Advice project in 2007, which found weaknesses in key areas of **firms' mortgage advice processes**. In the first quarter of 2008, we undertook a second review of around 250 firms to assess their advice processes. Firms were reviewed through a range of telephone assessments, visits and mystery shops. The reviews focused on six key areas of firms' advice processes; management controls; assessment of customer needs and affordability; recommendations, including product research; communications with customers; quality of advisers and post-sale activities.

We found that many of the areas identified during our first review remain a concern as firms have not made sufficient progress in key areas, such as affordability and gathering sufficient evidence to support the reasons for advice. Seven small mortgage advisers were referred to Enforcement as a result of this follow-up work and a further 23 were required to review customer files, which were found to contain insufficient evidence to explain and support the advice given. In August 2008 we told firms that they must significantly improve methods of establishing affordability, including gathering better evidence to support their reasons for advice and doing more to take customers' existing outgoings into account. The wider findings from the Mortgage Quality of Advice project continue to be addressed in the context of our assessment of firms' advice processes, as part of the small firms enhanced supervision strategy.

As a result of the Mortgage Quality of Advice work we fined four brokers a cumulative total of £73,000, issued three public censures, prohibited two individuals and cancelled two firms' permissions.

Following the 2007 implementation of our revised outcomes-focused **Conduct of Investment Business Sourcebook (COBS)**, we began a two-year post-implementation review of the effects of COBS changes. Throughout 2008, we sought the views of a sample of retail intermediaries and their advisers and visited a sample of larger investment firms (including affected insurance firms). We reviewed additional documentation obtained from our other relevant work and direct from firms, and solicited views from a range of stakeholders.

In December 2008, we published our statement of interim findings on how firms have responded to the COBS rule changes in the retail investment area. There was some indication that the firms in our review sample were focusing more on outcomes, rather than merely adopting a tick-box approach to complying with our rules. In early 2009, we published several examples of good and bad practice that we had identified, to help firms consider whether their own processes and documentation comply with our rules. The review will continue in 2009.

We contributed to the government's aim of extending understanding and take-up of the **Open Market Options (OMO)** under personal pension schemes. With TCF in mind we reviewed annuity providers' OMO literature and examined a selection of firms' processes and the time taken to make OMO payments. We published the results on our website in July 2008. Where necessary, we requested firms to amend their OMO literature and/or improve their OMO payment processes. As a result, pension consumers are much better placed to make informed decisions about exercising the OMO and faster payment times are now being achieved. We continue to participate in the government's monitoring of the OMO, and continue to liaise with the ABI about their own initiative to rationalise and speed up OMO payments.

The Pensions Act 2008 brings in **pension reforms** requiring all employers to enrol employees into a pension scheme automatically. The employer duty is expected to come into force in 2012. Under the provisions of the Pensions Act, a central occupational pension scheme (personal accounts) is being set up that employers will be able to use to meet their obligation. We have been working closely with the Department for Work and Pensions and the Personal Accounts Delivery Authority on the Pensions Act itself and the secondary regulations. We are discussing the potential market and regulatory impacts of the reforms, including where changes to our rules may be necessary, and have provided technical support on regulatory matters.

The **Thornton Review on Pensions Institutions** recommended the merger of the Pensions Ombudsman (PO) and the Financial Ombudsman Service (FOS) to create a simpler more coherent structure and deliver efficiency and effectiveness improvements. We have worked closely with DWP, the Treasury, FOS and PO to consider the recommendations in the Thornton report. Although the DWP decided not to proceed with a full legislative merger of the PO/FOS, clarity has been achieved on areas that would benefit from closer working between PO and FOS. We are continuing work as part of the PO/FOS closer-working initiative to ensure that the structure is simpler and more coherent for consumers.

The balance of **responsibilities between firms and consumers** has long been the subject of debate. Our December 2008 DP explored the steps we or others might take to help consumers understand and protect their own best interests more effectively. It set out our analysis of the basic legal position, how we take account of consumer responsibility in our decision making and suggested some sensible actions consumers might take to better protect their own best interests.

In addition to our work on monitoring firms' TCF progress we published a report on firms' awareness of and compliance with the **Unfair Terms** in Consumer Contracts Regulations 1999. The review found that while most of the firms surveyed said they had some systems and controls in place to review the fairness of their consumer contracts, these are not always producing the outcome of fair contract terms. In a separate review of legal expenses insurance contracts, we found that some insurers had the same or similar terms in their contracts we viewed as unfair two years previously. In light of the report and our review of legal expenses insurance, we reiterated our views that firms should remain alert to other firms' published undertakings and consider their own contracts in line with them.

During the year we published nine undertakings that resulted in unfair contract terms being removed or amended from firms' contracts. We believe that our publications encouraging firms to review other published undertakings have improved their awareness of and compliance with the regulations. We also emphasised our views to firms on the appropriate use of legalistic terminology in consumer contracts to help them meet the regulatory requirements to use plain and intelligible language in their contracts.

We also addressed concerns with certain terms we have seen in mortgage contracts where the interest rate tracks a benchmark rate. This enables some firms to impose a floor, or to determine the interest rate payable by the consumer, once a certain 'trigger' in the benchmark rate is reached. We made it clear that while we are not concerned with the fairness of an interest rate floor as such, we urged firms to ensure that they are drafted in a way that is balanced and fair. Furthermore we required firms to ensure that the consumer is made aware of the existence of a floor, trigger or similar feature in an appropriate manner and at both the pre-application and offer stages, in accordance with our Mortgage Conduct of Business rules.

In December 2008, we published an FS setting out our approach to addressing concerns that **commercial general insurance** customers may be poorly informed about how (and how much) their intermediary is being paid, about the services being provided and also the capacity in which their intermediary is acting. In March 2009 we confirmed industry guidance developed by the British Insurance Brokers' Association and the London and International Insurance Brokers' Association. The work is designed to help intermediaries provide clearer and more consistent information to their customers about their capacity, the services being provided and their remuneration.

Our approach was based on the evidence from a programme of work we undertook in 2008/09 that included:

- analysis of responses to a DP;
- independent research into how customers use information about their intermediaries' commission; and
- thematic work by our supervisors into whether certain types of intermediary remuneration and/or the distribution of commercial general insurance gave rise to unmanageable conflicts of interest.

The FS set out five outcomes for commercial customers designed to provide them with clearer and more comparable information about their intermediaries' remuneration (including their right to request commission information), services and capacity. Our findings had indicated that although intermediaries are largely managing conflicts of interest appropriately, more should be done to improve transparency.

### Climate change

In our 2008 *Financial Risk Outlook*, we highlighted the fact that climate change is increasingly becoming a key risk to the insurance sector as changing weather patterns may result in higher and more frequent claims. Last year we conducted a review of 25 firms to see whether they are providing their customers with clear and accurate information about the scope of their cover and any significant exclusions. We issued a response to each firm during March 2009 that detailed feedback from the findings and actions we expect firms to take in the future. To help consumers improve their understanding of the relevant issues we also updated *Moneymadeclear*, our website for consumers. As part of our ongoing work in this area we will continue to communicate our findings with stakeholders.

## CONDUCT OF BUSINESS REGULATION (COB) OF RETAIL BANKING

At present we are not directly responsible for the conduct of business of retail banking, which is instead still agreed by self-regulation, via the Banking Code. But we have been actively involved in issues relating to unauthorised overdraft charges, and we have now decided to bring retail banking COB more formally within our remit.

### Unauthorised overdraft charges

Our work in this area has sought to address issues around inconsistencies where some customers who complained were being refunded charges while others were not. In 2007 when the Office of Fair Trading (OFT), seven UK banks and one building society began a test case in the High Court to resolve legal uncertainties about unauthorised overdraft charges, we granted a number of banks and building societies a 'waiver'. In effect, this meant that banks and building societies could put customer complaints on this issue 'on hold' until the legal position of the charges is more certain. After the first waiver expired in July 2008, we granted a second waiver that we have now extended to July 2009.

In operating these waivers we have also ensured that consumer interests are protected. Since July 2008 we have enhanced our monitoring of firms' treatment of consumers in relation to unauthorised overdraft charges. Our focus is on ensuring that firms with the waiver are complying with its requirements, which includes identifying complainants facing financial difficulty who need extra help. We also monitor changes by firms to the level or structure of their unauthorised overdraft charges, to ensure that these changes have not had a materially adverse effect on their customers. We continue to work with the OFT and the relevant firms so that this issue can be resolved as quickly as possible.

### Future regulation of retail banking COB

In November 2008 we set out, for consultation, a proposed new framework for regulating retail banking COB within our remit. Since we assumed our powers under FSMA in 2001, we have not made comprehensive rules governing the conduct of retail deposit-taking business. Self-regulation of banking COB has continued, with the Banking Code Standards Board (BCSB) monitoring and enforcing compliance with the voluntary Banking Codes for dealing with personal and business customers. Although these arrangements have generally worked well for deposit taking, we have decide to review whether they remain the right model for the future, particularly in light of our responsibilities under the

Payment Services Directive (PSD) and the prudential and conduct risks affecting the whole of firms' retail market activities.

We have proposed:

- full application of the Principles for Businesses to the activities of accepting deposits and issuing e-money (to the extent compatible with European law);
- some new high-level rules applying to retail banking services outside the PSD scope for consumers and small businesses in a short Banking Conduct of Business sourcebook (BCOBS);
- locating our existing COBS rules and guidance applying to deposit taking in BCOBS; and
- monitoring and enforcement by us, integrated into our wider risk-based approach to the supervision of the relevant firms and groups.

## CONSUMER EDUCATION

One of our statutory objectives is to promote the public's understanding of the financial system. It is important that people have the knowledge and skills to plan ahead and take the necessary steps to protect themselves against unexpected circumstances, such as a drop in income. Our work in this area is all the more important, given the continuing financial crisis. Through the National Strategy for Financial Capability, we aim to give consumers the tools and knowledge to engage with financial services more confidently and capably, and make more informed decisions. Over the last year, we have achieved most of our targets, and in some places exceeded them. We estimate that so far the programme has reached 6.5 million people, exceeding our target of six million; by 2011 (the end of our five-year strategy) we aim to reach 10 million people. A detailed description of our progress is given in Appendix 7, published on our website, but highlights include:

- Our *Learning Money Matters* programme, delivered by the Personal Finance Education Group, helped 3,274 secondary schools in England provide effective personal finance education, exceeding our target of 2,900 schools. We welcome the government's intention to make personal finance education a statutory part of the curriculum in England. We reached 1,000 schools in Scotland, Wales and Northern Ireland, exceeding our target of 250.
- We promoted the *Money for LiFE* initiative to all 450 UK Further Education colleges. We also extended the pilot to over 60 colleges in three English regions, Northern Ireland, Scotland and Wales, benefiting over 27,000 learners. This exceeded the target of 50 colleges and 11,000 learners. We achieved this by extending support to the colleges that helped develop the Money for LiFE CD resource and by funding sector organisations during the 2008/09 academic year to give staff the confidence and means to begin planning financial capability activities in their colleges.
- We produced a strategic business case to help influence decision-makers in universities to adopt the *Money Doctors* initiatives. As a result, we have worked with 67 universities to implement the *Money Doctors* project.
- We exceeded our targets for our programme for young adults who are Not in Education, Employment, or Training training 5,000 youth work intermediaries against a target of 3,500. At the end of a training day, 83% of practitioners expressed confidence in supporting young people with money matters.
- We successfully rolled out the *Parent's Guide to Money* nationally and achieved our target of distributing 500,000 guides to new parents. Based on a sample of 1400 expectant mothers, 58% said they felt more confident with finance and 65% said they felt more capable, as a result of reading the guide.
- Our workplace project delivered 1.7 million copies of our *Making the most of your money* guide or CD-ROM through employers and trusted intermediaries, exceeding the target of 620,000. We presented the workplace seminar to over 46,300 employees against a target of 30,000. Based on a post-seminar sample of over 13,000 attendees, 69% felt more confident about dealing with money matters, 81% felt they had increased knowledge about money issues, 79% felt they had increased skills to deal with money matters and 31% started to save more money.
- We partnered national and local organisations to deliver tailored financial information and guidance to the following sectors: autism, learning disabilities, mental health, offending and social housing. Partners included the National Autistic Society, Mind, the Chartered Institute of Housing and the Royal College of Psychiatrists.
- Following the publication of the Thoresen Review of Generic Financial Advice in March 2008, the Treasury asked us to design, develop and deliver a money guidance pathfinder to test the review's blueprint for a national service. Operational testing of the pathfinder courses, which is being delivered under the *Moneymadeclear* brand, started on 31 March 2009 and the official launch took place in April 2009. The *Moneymadeclear* service is being run in the north east and north west of England

and aims to reach up to 750,000 people online, over the telephone and through face-to-face meetings in a 12-month period. It provides people with access to more personalised information and guidance on a range of money matters, such as budgeting, saving and borrowing, mortgages, insurance, pensions and planning for retirement, and tax and benefits. The government announced in the 2009 Budget that the roll-out of a national money guidance service will begin in 2010, subject to preliminary findings from the pathfinder demonstrating that the service can be effective.

- We continued our programme of advertising campaigns promoting the website and printed guides (also branded *Moneymadeclear*) as a source of clear, impartial information to help consumers make better-informed decisions. By the end of June 2008, we achieved the target to double visits to the *Moneymadeclear* website from two million to four million between 2006-2009. We successfully delivered a mortgages campaign in Q2 2008 and received around 660,000 visits to the website during this period, over three times the average number of visits in a non-promotional month. During the campaign, 72% claimed that they were more likely to make an informed decision as a result of their visit.
- We created a new comparison table in Q2 2008 to help consumers shop around for PPI. We are expecting further enhancements to the *Moneymadeclear* website as part of work to develop the money guidance digital offering.
- In Q2 2008 we launched *What about money?*, a website specifically for 16-24 year olds. It was designed to appeal to and engage young adults and provide help and information relevant to their needs. We ran a successful promotional campaign in Q1 2009 that resulted in over 127,000 visits to the website. This represents a 21 fold increase in visits since the advertising began.

In addition to our *Business Plan* commitments, we have begun to explore the needs of over 40s, those facing divorce and separation and those unemployed or at risk of redundancy, with a view to developing further initiatives for these groups.

With the Treasury, we also published the **Joint Action Plan for Financial Capability** in July 2008, setting out a range of measures to offer targeted support on managing finances, reflecting that people most need support at key points in their lives. This included delivery of a Treasury-funded campaign in Q3 2008 to promote *Moneymadeclear* and our Consumer Contact Centre, to help people manage their money better in challenging economic times. Of those surveyed, 81% claimed that they will take some action in the next six months as a result of visiting *Moneymadeclear*, 38% will cut back on unnecessary spending and 37% will switch, revise or cancel financial products.

## OTHER EXTENSIONS OF THE FSA'S SCOPE OF RESPONSIBILITY

### Connected travel insurance

In May 2008 we published a Policy Statement setting out the final rules for regulating travel insurance sold alongside a holiday – known as Connected Travel Insurance (CTI). This is mainly sold by travel firms and holiday providers. The new proportionate, risk-based regime came into force on 1 January 2009.

The key benefits for consumers are firms offering these products have the right resources to sell CTI, deal appropriately with consumers and have staff who are competent to undertake this business; consumers will get clear, concise and consistent information about a firm's services and products on offer so they can make informed choices; and if things go wrong, consumers are able to obtain redress. Travel firms had to decide whether to be authorised by the FSA, be an appointed representative of an FSA-authorised firm, be an unregulated introducer (and only effect introductions or distribute financial promotions not made during a personal visit) or no longer offer CTI products.

### Payment Services Directive (PSD)

In 2009 payment services will be subject to a single, regulatory regime, the Payment Services Regulations 2009, implementing the PSD. During the past year we published two CPs and an Approach Document outlining our proposals and subsequent final rules. The PSD seeks to enhance competition, efficiency and innovation in the European payments market and establish standardised rules across the EEA on the information requirements and the rights and obligations of payment service providers.

To achieve these aims, the PSD:

- introduces a new prudential authorisation regime for larger payment-services firms that are neither banks, building societies nor e-money issuers;
- allows smaller payment-services firms operating beneath a certain threshold to be registered under the PSD instead of obtaining authorisation; and
- sets out COB requirements on the information to customers, as well as the rights and obligations of providers and customers.

The government has appointed us as the competent authority for most aspects of the regime. We have put in place a proportionate regime to meet our responsibilities under the regulations and are currently on track to begin accepting applications from 1 May 2010. The implementation of PSD begins on 1 November and finishes on 1 May 2011.

## Regulating reclaim funds

The Dormant Bank and Building Society Accounts Act 2008 brought a new type of firm into our regulatory scope – called a 'reclaim fund'. Reclaim funds will be unique types of financial institutions with the characteristics of both a bank and an insurer. Dormant accounts will be transferred to them and, after estimating the percentage of deposits likely to be reclaimed by consumers, they will be under an obligation to transfer surplus money to the government's Big Lottery Fund. To address this new responsibility, we published a CP in February 2009 setting out our proposals for a sound outcomes-focused, proportionate and cost-effective regime for the regulation of reclaim funds. The CP explains our proposed authorisation process, prudential requirements and other consequential changes we will need to make to our Handbook.

## Sale and rent-back (SRB)

A market study conducted last year by the Office of Fair Trading (OFT) found sale and rent-back (SRB) schemes posed serious risks to consumers. SRB schemes involve individuals selling their home, usually at a discount, and obtaining an agreement to remain in the property for a set period – typically through an assured short-hold tenancy of six to 12 months. The government accepted the OFT's main recommendation of our regulation, and in February 2009 the Treasury published a consultation proposing legislative changes to bring this about. In parallel with this, we have published our own CP setting our proposals for the regulation of SRB schemes.

Our CP proposed a two-stage approach: an interim regime to be brought in from July to address the most significant problems consumers face as soon as possible, followed by a full regime likely to be implemented in 2010. Under the interim regime, SRB firms will need to meet our threshold conditions, to adhere to the Principles for Businesses and to meet some systems and controls and COB rules. We will consider in 2009 whether full authorisation, prudential requirements and further COB rules should be applied for the second stage of the regime.

# Improving our business capability and effectiveness

## INTRODUCTION

As firms and consumers have struggled with the challenges of the financial crisis we have continued to consider how we can make it easier to do business with us. This approach is consistent with the legislation, which requires us to have regard to the need to use our resources in the most efficient and effective way and to the principle of proportionality in the regulatory burdens or restrictions we impose. We continued to invest in our people and technology to further these aims and objectives and we made structural changes that have delivered a more efficient way of working across the organisation.

## PEOPLE

### Reward

In challenging market conditions, it is vital that we put in place a reward strategy that supports our objective of further improving and maintaining the quality of our staff. During 2008/09 we reviewed our strategy, taking into account all elements of the remuneration package and made recommendations for change, effective from 2009/10. Our revised strategy offers a common platform of rewards to all staff, with more transparency between skills, contribution and total rewards.

Part of the revised strategy included a proposal, which we are consulting on, to cease future contributions to the final salary section of the pension plan. The new reward philosophy is designed to ensure competitive and market-aligned total remuneration and a more equitable distribution of reward spend.

### Leadership development

As part of our focus on leadership development in 2008, we implemented some further measures. This included upgrading our 360° review process, improved measures in the all-staff survey, an Executive Development Programme (EDP), as well as enhancing our performance management approach to secure higher levels of performance from staff. All senior staff attended the EDP and received detailed personal feedback on leadership behaviours. Personal development plans were put in place and then monitored and reviewed. EDP measures have shown an increase in leadership capability, along with positive results from the staff survey.

We have clear succession plans in place for key senior roles and are actively developing managers on technical depth through the SEP. We have launched our new approach to Training and Competence (T&C), outlined in Section One, which continues to deliver technical depth and expertise, as well as improving the capability of management and leadership behaviours.

### Focused training

Following a review of how we deliver internal training and development programmes we undertook a comprehensive analysis of our training needs and implemented a programme of interpersonal skills and supervisory training. This programme continues to be a success; this ensures that knowledge and skills are retained and transferred back into the workplace through learning and development planning linked to the performance management process.

All existing relationship management supervisors have been provided with core training on key technical areas to enhance their skills and knowledge. This training is supported by robust assessments to ensure standards are being delivered into the supervision process.

## BEING AN EMPLOYER OF CHOICE

Despite the challenges we have faced over the past year, our staff have remained engaged and committed to our aims; this was reflected in a positive set of results from our annual staff survey. Our annual turnover is within industry norms and was 6.9% at March 2009. We recruited 50 graduates in 2008, including three onto our specialist Actuarial and Management Accountancy Programmes; retention on the programme remains above 90%, which is high in comparison to the industry average. Interest on campuses around the UK in our Graduate Programme is extremely high and we received more than double the applications for the 2009 intake compared to the previous year. Externally, we have maintained a positive profile and have attracted significant interest in our additional supervisory recruitment, which is outlined in Section One.

### OFFICE ACCOMMODATION

In 2008 we completed the refurbishment of our working environment, which included upgrades to the building and IT infrastructure in our Canary Wharf office. This refurbishment included a complete redesign of the workplace. The flexible workplace allows us to accommodate more staff in 25 The North Colonnade. In addition we have taken out a long-term lease on a floor in One Canada Square, to accommodate increased staff numbers.

### IMPROVING OUR TECHNICAL INFRASTRUCTURE

#### Transformation programme

The IS transformation programme was launched in August 2005 and is now nearing completion. During the past year we benchmarked ourselves against our peers and established IS models, to assess whether we have appropriate IS processes and controls in place. We completed this work by our target date of March 2009 and are currently awaiting external verification of our performance. Two key deliverables of this transformation work were implementing technology to enable flexible working; and the migration of most of our systems to external data centre facilities to enhance operations and enable significant development activities.

Working with our Application Development Framework partners, we have been able to deliver more than twice as much IS project development as before and are achieving exceptional levels of productivity through the effective use of our partners' development centres. This leaves us well positioned to deal with the further increase in demand for 2009/10 and ensures we obtain best value for us from our IS development expenditure.

#### Knowledge infrastructure programme (KI)

As part of our KI programme we started work on a number of technical upgrades during the year. Once complete, these upgrades will enable us to implement a new search capability that will greatly improve our ability to utilise our vast resources of information, while at the same time improving the efficiency of how we work. We also began work on delivering an enhanced Web Content Management system that will improve the way we use the web as a communication and information-sharing resource. The development of these tools will enhance our ability to react quickly, efficiently and consistently to changing circumstances and, most importantly, to communicate to our various stakeholders information that is relevant to them.

### INTEGRATED REGULATORY REPORTING (IRR)

#### GABRIEL

Together with our IS suppliers we implemented GABRIEL (GAthering Better Regulatory Information ELectronically). Designed to act as the central system in the collection, validation and storage of regulatory data, it went live in August 2008 and was rolled out to firms in three phases.

i. August: Firms subject to the Capital Requirements Directive (CRD), and certain other deposit takers.

ii. September: Firms not subject to the CRD requirements and Electronic Money Institutions.

iii. October: Retail mediation firms, mortgage lending and administration firms, and those firms who were only required to complete the complaints requirement.

GABRIEL has generally performed well since August 2008; however, there were some problems in late October and November 2008, which resulted in some firms experiencing difficulties in submitting their data. We apologised for the inconvenience caused to firms, and ensured the problems received urgent attention. We implemented additional system upgrades in November that improved performance significantly. Where appropriate, we will continue to implement upgrades to improve the system.

Around 20,000 firms have activated their accounts; and some 200,000 data items have been submitted through GABRIEL to date. Firms are able to see their 12-month rolling reporting schedule, with details of what and when they are required to report under GABRIEL without having to refer to our Handbook. Storing and accessing data in one place enables us to identify risks more effectively, helping supervisory areas to prioritise and allocate resources more efficiently.

Throughout the development of GABRIEL, we worked closely with our key external stakeholders, using three key technical discussion forums: the IRR Advisory Group, the IRR Industry User Group, and the Independent Software Vendor Discussion Group. These groups gave us the opportunity to obtain feedback from trade associations, regulated firms and software vendors on system design, related processes and communications. They also helped to improve firms' understanding of the IRR programme and regulatory reporting.

## CORE REGULATORY TRANSACTIONS

In the market conditions during the past year we observed both a significant increase in the numbers of applications to cancel authorisation permissions and a decrease in the number of applicants seeking corporate authorisation (see Table 4.1). In particular, there was a reduction in applications from firms seeking mortgage and general insurance mediation activities. Similarly, market conditions were the main reason for a reduction in the number of approved person applications. For applications for Variations of Permission, previous years' numbers had been inflated by increases in our regulatory scope. Applications last year often arose from firms' desire to reduce their activities in order to minimise regulatory costs and reporting requirements.

Table 4.1

| Core regulatory transactions | Received during 08/09 | Received during 07/08 |
|---|---|---|
| Cancellations | 2,995 | 2,089 |
| Corporate authorisations | 1,375 | 1,941 |
| Individual approvals * | 40,997 | 47,305 |
| Variations of permission | 2,068 | 2,930 |
| Changes of controller | 1,837 | 1,804 |
| Collective investment schemes | 1,027 | 959 |
| Waivers | 527 | 1,172 |
| Passporting | 2,828 | 3,330 |

* Excludes individual applications linked to corporate applications (2008/09: 3,993 – 2007/08: 4,873)

For change in control applications there were two main themes during the year. First, responses to market conditions saw the approval of a number of new controllers, including government stakes, both in the UK and overseas. Second, the trend of more complex applications, noted in last year's report, continued and concerns we identified about the suitability of prospective controllers resulted in the issue of six warning notices (up from three in the previous year). In addition, following our close scrutiny some applicants withdrew before we reached a formal decision.

While the number of applications grouped under collective investment schemes increased slightly year-on-year, there was a significant underlying change. There has been a noticeable reduction in applications for new schemes, though this was more than offset by the increased number of applications to reorganise and rationalise existing schemes. This is unsurprising given market conditions during the period.

There has been a large decrease in the need for applications for waivers; this is a direct result of the recent updates to several FSA sourcebooks. Approximately 60% of the applications we received in 2008/09 were for waivers or modifications of rules relating to prudential matters. More generally, the level of scrutiny given to new applications in all core regulatory transactions, including interviews relating to applications for SIFs has reflected changing market conditions and our more intensive approach to supervision.

## ECONOMY AND EFFICIENCY

### Service standards

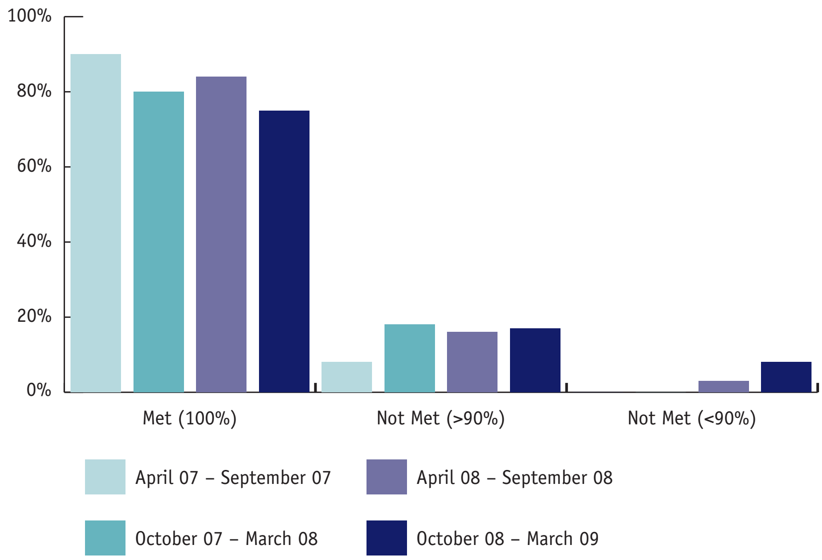
Our service standards apply to many aspects of our work, including replying to correspondence, answering the telephones in our contact centres and making and communicating regulatory decisions. We publish a twice-yearly account on our website of our performance against our service standards. Over the past year we have rationalised our standards and made them clearer and easier for our stakeholders to understand. The resulting portfolio of standards allows us to report on some major aspects of our work.

Chart 4.1 shows our performance against the standards for the last four years. The results in the latest reporting period (1 October 2008 to 31 March 2009) show a decline in performance compared to the previous period (1 April to 30 September 2008). As outlined on the chart, between October 2008 and March 2009 we recorded 1.2 million transactions, of which we serviced 0.9 million within the service level target. When compared to the same period a year ago, when we received 0.8 million transactions and successfully dealt with 0.6 million, this represents a 40% increase in volume, or in real terms some 300,000 extra transactions. The performance standard achieved is a good result considering increased volumes, largely caused by more firms and consumers requiring our assistance, and greater complexity of cases as a result of market conditions during this period. In the coming year we will commit extra resources to improve these results.

We are always seeking to improve our performance and continually review the portfolio of standards, implementing necessary changes at the beginning of each new six-month reporting period. As part of work to rationalise our standards and make them easier for our stakeholders to understand, we made a number of changes, in particular to clarify definitions and adjust benchmarks where appropriate. In April 2008 we introduced three new standards:

- Money-laundering registrations – introduced to measure volumes of money-laundering registrations processed.
- Cancellation of applications – extended the scope of the existing cancellation standards by removing the reference to low-complexity applications. Where standards have been combined, we will remove existing individual standards.
- Customer-facing IS systems – extended the scope of our customer facing systems' availability from three to seven. We combined the existing standards – Firms Online, Electronic Listing Service (ELS), GABRIEL and our Register systems – with the performance of our website, Compare Products and Fee Calculator systems, to form this standard.

Chart 4.1: Performance against service standards




We have also removed a number of standards from the portfolio that attracted low volumes of applications/requests. While we have removed these from external reporting, we have continued to measure their performance internally. In 2009/10 we plan to carry out a strategic review of the existing standards to ensure that they continue to be relevant, challenging and the most appropriate indicators of our performance. We will report key findings and recommendations in the 2010 annual report.

## CONTACT CENTRE CHANGE PROGRAMME

The consumer and firm contact centres have now been integrated under one management to form the Customer Contact Centre (CCC). This is enabling us to deliver more efficient and effective services to firms and consumers. The unit has been able to incorporate individual helplines from other parts of our organisation, as well as introduce new services such as proactive outbound campaigns. We have also made investments in resource scheduling, knowledge management and training and development to ensure contact centre staff are fully equipped to provide the service that customers require. The CCC has retained the Contact Centre Association Quality Award as a combined unit and has maintained excellent customer satisfaction survey results during the year.

During 2008/09 our CCC received 149,299 calls and 21,812 items of correspondence from firms. The volume of firm telephone queries continued to increase, compared to 121,823 in 2007/08.

Queries relating to regulatory reporting were the most common and we also noted an increase in queries from firms requiring assistance to deal with the challenging market conditions. Overall, the distribution of calls by topic was similar to 2007/08 (see Chart 4.2).

The CCC also received 237,458 calls from consumers, a significant increase compared to 185,250 received in 2007/08. This increase in calls reflects the difficult economic climate and consumers becoming more aware of our regulatory responsibilities to protect consumers. We saw an increase specifically in enquiries about FSCS compensation limits, which contributed significantly to the increase in 'Investment' related calls, 171,358 up from 124,764 the previous year. There were also similar increases in our correspondence levels where we received 2,942 compensation enquiries compared to 577 in 2007/08 (see Chart 4.3).

Chart 4.2: Telephone calls received in the Firm Contact Centre split by topic 1 April 2008 to 31 March 2009

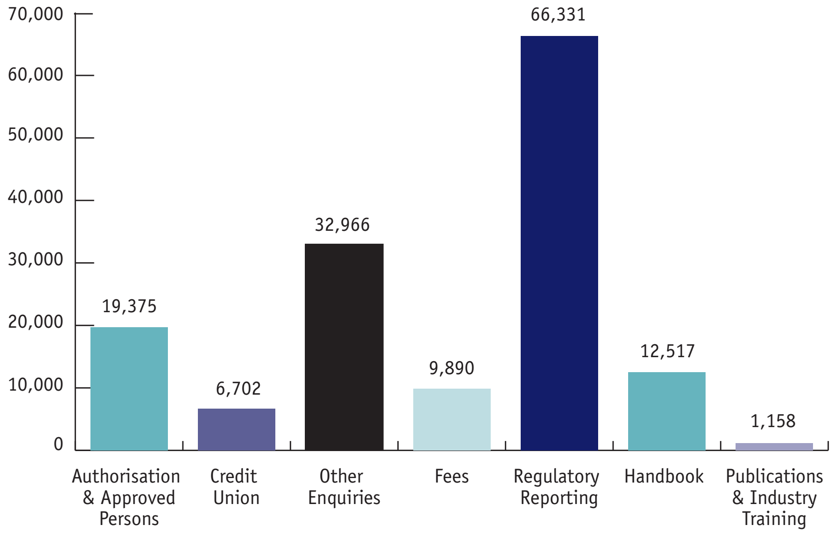
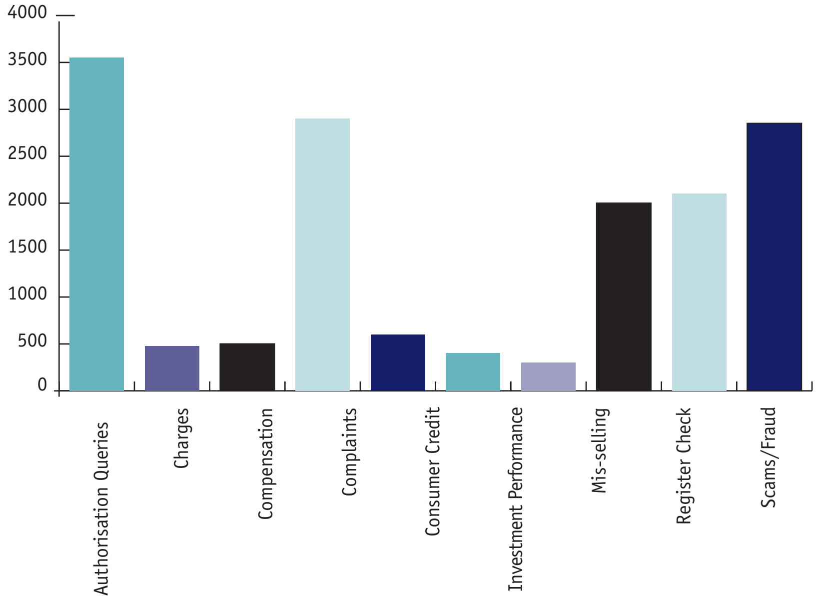



Chart 4.3: Correspondence received in the Consumer Contact Centre split by topic 1 April 2008 to 31 March 2009



# 2008/09 Financial review

## BASIS OF PREPARATION

This financial review is based on our Financial Management Reporting framework as updated in our Business Plan 2009/10, and set out in Box 12 in this section. 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 of our costs, including those created by pensions accounting. Under this framework, our net costs are identified as those of our Ongoing Regulatory Activities (ORA).

Table 5.1 shows £15.9m of expenditure relating to implementing more outcomes-focused regulation. In 2007/08 we explained our intention to spend up to £50m, in addition to our ORA, over a number of years on a programme of change across the organisation. This investment will lead to benefits that will be realised over a longer period and will contribute to our move to a more outcomes-focused regulatory approach. The 2008/09 expenditure includes staff costs, such as redundancy, retention payments and additional staff (£4.5m), computer development work (£3.6m), and the costs of making the working space in our head office more flexible and efficient.

Table 5.1
Reconciliation of statutory accounts to the financial review

| | £m |
|---|---|
| **Net cost for the year per the statutory accounts** | **346.5** |
| **Add:** Taxation | 0.9 |
| **Net costs for the year (including taxation) per the statutory accounts** | **347.4** |
| **Add:** difference between accounting charges for provisions in the statutory accounts and the related cash costs of pension contributions paid | 6.0 |
| **Less:** scope change | (2.5) |
| **Less:** costs of implementing more outcomes-focused regulation (formerly more principles-based regulation) | (15.9) |
| **Net costs for the year of our Ongoing Regulatory Activities (ORA)** | **335.0** |

In addition to our ORA expenditure of £335.0m and transition costs of £15.9m, we also spent £2.5m for items that represented additional scope for the FSA. This expenditure on increased scope included work on the Payment Services Directive, Sale and Rent-back schemes, and Unclaimed Assets.

## NET EXPENDITURE

### Cost of our Ongoing Regulatory Activity (ORA)

The original budget published for 2008/09 of £323.0m was adjusted during the course of the year. The FSA Board approved an additional expenditure of £13.6m for the Supervisory Enhancement Programme (SEP) and a required change in accounting treatment for the building maintenance (Lifecycle) costs (£1.8m), leading to a revised budget of £338.4m.

Our net costs for the year (excluding costs associated with more outcomes-focused regulation and scope changes) were £335.0m. This is £3.4m less than the revised budget and brings our ORA reserves to £nil, as we have taken the opportunity to maximise the write off of our remaining deferred IS costs of £3.4m. The tables on page 58 analyse in more detail the actual and budgeted total costs for 2008/09, by cost type and function.

## Net expenditure by type

Staff costs were £3.2m higher than budgeted in the year. This is mainly due to higher than expected spend on contractors brought in to meet workload demand in both supervisory areas and projects. Partially offsetting this were lower training costs, reflecting both the deferral and more efficient delivery of training activities.

Accommodation, office services and depreciation was £2.9m under budget, as timing of projects resulted in lower depreciation charges.

Professional fees for projects were under budget by £5.2m due to the timing of certain projects and lower than planned spend on Financial Capability. This was partially offset by additional expenditure on professional fees for services, which were higher than budget by £1.3m.

Sundry income primarily relates to application fees (£12.2m) and interest earned on deposits (£5.7m), with the balance mainly due to transaction reporting fees, the sale of publications, and training services.

In our 2009/10 Business Plan, we stated that we were deferring an estimated £9.5m of capital expenditure relating to elements of Knowledge Infrastructure and Sabre II projects from 2008/09 to 2009/10. The 2008/09 budget has accordingly been reduced by this amount. Actual capital expenditure was £2.4m lower than this reduced budget, mainly due to a reduction in refurbishment expenses of £1.7m and overall underspends for projects and infrastructure of £0.7m.

## Expenditure by business unit

Overall, we have kept our costs within the total revised budget by allocating resources to our highest priorities, such as SEP, and funding this by reducing spend on other activities.

**Table 5.2**
**Net expenditure by type**

| | 2008/09 Actual £m | 2008/09 Budget £m | 2008/09 Variance £m |
|---|---|---|---|
| Staff Costs (inc. travel, training, recruitment and pension scheme deficit reduction contributions) | 249.6 | 246.4 | (3.2) |
| Accommodation, office services and depreciation | 44.8 | 47.7 | 2.9 |
| IT costs (including IT delivery outsourcing) | 26.9 | 26.7 | (0.2) |
| Professional fees – services | 15.3 | 14.0 | (1.3) |
| Professional fees – projects | 16.8 | 22.0 | 5.2 |
| Printing, publications and other | 6.2 | 4.8 | (1.4) |
| | **359.6** | **361.6** | **2.0** |
| Sundry income | (24.6) | (23.2) | 1.4 |
| **Total ORA** | **335.0** | **338.4** | **3.4** |

**Table 5.3**
**Expenditure by business unit**

| | 2008/09 Actual £m | 2008/09 Budget £m | 2008/09 Variance £m |
|---|---|---|---|
| Retail Markets Business Unit | 161.1 | 162.1 | 1.0 |
| Wholesale and Institutional Markets Business Unit | 88.8 | 86.8 | (2.0) |
| Operations Business Unit | 30.2 | 33.4 | 3.2 |
| Direct Reports Business Unit | 43.7 | 43.6 | (0.1) |
| Enforcement | 35.8 | 35.7 | (0.1) |
| | **359.6** | **361.6** | **2.0** |
| Sundry Income | (24.6) | (23.2) | 1.4 |
| **Total ORA** | **335.0** | **338.4** | **3.4** |

The Retail Markets Business Unit made savings in non-supervisory areas that offset higher costs in their core supervisory activities. The Wholesale Business Unit spent slightly more than expected on specific supervisory activities.

The Operations Business Unit shows a favourable variance to budget reflecting lower depreciation charges due to timing of IT projects.

Direct Reports and Enforcement costs were broadly in line with budget.

## Enforcement costs and penalties

Our Enforcement costs were £35.8m for 2008/09 (£29.4m 2007/08), which included the cost of external accountants and lawyers (£3.8m in 2008/09; £0.9m in 2007/08), brought in to help us with large or complex enforcement cases.

As in previous years, we neither budget for penalties arising from disciplinary cases nor use them to fund our activities. During 2008/09 we collected penalties of £28.4m (2007/08: £4.5m), which will be used to reduce the amounts payable to us by relevant fee blocks in future years.

## Panel costs

Panel costs include the cost of the Consumer Panel (£0.7m) and the combined cost of the Practitioner and Smaller Businesses Practitioner Panels (£0.5m). 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 costs of both these panels were in line with budget.

## Complaints Commissioner

The FSA provides funding for the Office of the Complaints Commissioner (OCC), which incurs costs mainly comprising of the Commissioner and his staff, accommodation and ancillary services. In 2008/09, the OCC's costs totalled £0.5m, which was in line with budget.

## Funding

We are funded by fees payable by the organisations we authorise, recognise, register or list. During 2008/09, £324.4m in fees were raised directly from those fee-payers. The shortfall in fees shown in table 5.4 reflects the fact that fees were set before the budget was revised to fund the additional SEP and Lifecycle costs.

### Table 5.4
### Funding the FSA's net expenditure

| | 2008/09 £m | 2007/08 £m |
|---|---|---|
| Total net costs for the year per the Financial review | 335.0 | 298.1 |
| Under spend against budget (see reserves movement table 5.5) | 3.4 | 3.6 |
| (Shortfall)/excess of fees over budget (see reserves movement table 5.5) | (14.0) | 1.6 |
| **Fees raised in the year** | **324.4** | **303.3** |

## BALANCE SHEET

## Financial Strength

The statutory accounts show that we had net liabilities of £123.1m at 31 March 2009, primarily as a result of pension liabilities of £88.9m, calculated under International Accounting Standard 19: Employee Benefits (IAS 19). The pensions liabilities will not crystallise for many years and our approach to managing them, and to funding our pension deficit, is explained on pages 59 to 60. Despite the large deficit currently reported, we believe that we remain able to meet our liabilities as they fall due because of our statutory power to raise fees. Accordingly, our financial statements have been prepared on a going concern basis. Excluding the pensions deficit measured on an IAS 19 basis, we had a net deficit of £34.2m, some of which was generated by the extra budget approved for SEP and Lifecycle costs. These will be recovered by fees in 2009/10.

During 2008/09, our cash balance averaged £56.2m (2007/08: £92.8m), and totalled £0.2m at the year end (2007/08: £24.8m).

During 2006/07, we investigated options to improve the management of the risks to our balance sheet and to our fee-payers. As a result of that work, we paid an additional £20m into the Pension Plan and arranged a £100m revolving credit facility with Lloyds Banking Group to fund the costs we expect to incur in delivering more outcomes focussed regulation and overhauling our IT delivery and technical infrastructure. This allows us to spread the costs to fee-payers over several years. The price of that facility appropriately reflects the strength of our financial covenant. The revolving credit facility with Lloyds Banking Group remained in place during 2008/09 and, following the continuation of our capital investment programme, we had to draw down on the facility to fund a short term deficit in our liquid resources towards the end of the year.

Based on the activities in our 2009/10 Business Plan, we identified the need to extend our credit facility. Accordingly, we have recently entered into a similar revolving credit facility arrangement with HSBC for a further £100m facility.

## Financial management of the FSA's pension costs

Our pension scheme has two sections, Final Salary and Money Purchase. The Final Salary scheme has been closed to new members, other than staff transferring from previous regulators whose activities we have taken on, since 1 June 1998. At 31 March 2009, 495 staff (31 March 2008: 538) were in the Final Salary scheme and 2,127 (31 March 2008: 1,876) in the Money Purchase scheme. The Final Salary scheme is relatively immature compared to many such schemes, in that just under 16% of members of the scheme are pensioners.

In our Annual Report for 2007/08, we committed to making a minimum additional pension deficit reduction contribution of £3.8m to our Final Salary pension scheme during 2008/09. Following discussions with our actuary and the Trustee of the Pension Plan, we increased this to £5.8m. We also raised £2.5m to fund repayment of the £20m additional contributions we made from our reserves during 2006/07. Key factors impacting the value of our pension deficit included:

- the increase in the corporate bond discount rate from 6.0% to 6.6% reduced the deficit by £49.4m; and
- a decrease in the retail price inflation assumption from 3.4% to 3.0% reduced the deficit by a further £26.5m.

Other factors affecting the value of our pension deficit included interest costs, expected return and an actuarial loss on our assets. After taking all those factors into account, the deficit decreased by £2.7m to £88.9m, as measured using IAS 19.

We continue to work with the Final Salary pension scheme Trustee to secure the pension benefits of our employees and mitigate the risks arising from our Final Salary pension scheme. In particular, in March 2008 we agreed with the Trustee both the results of the Scheme Specific Valuation (SSV), performed as at 31 March 2007, and the basis on which we shall pay contributions until the next three-yearly valuation is completed. The SSV showed a deficit of £29m. In 2008/09, we committed to making additional pension deficit reduction contributions of £3.8m a year (approximately 13.1% of pensionable earnings). In the event, we made pension deficit reduction contributions totalling £5.8m (19.9% of pensionable earnings) in 2008/09. We remain committed to clear the deficit over the ten–year period to 2019 by making additional pension deficit reduction contributions. We have committed to raise our deficit contribution to £9.8m in 2009/10, and make payments of £11.8m a year, beginning in 2010/11. 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

We believe that our total revolving credit facilities (£200m) provide sufficient financial capacity to allow us to meet any likely unforeseen expenditure. Consequently, we target a level of reserves (that is the cumulative excess of our fees over our costs) of £nil (+/-2%) of the cost of our ORA. We have taken the opportunity within our ORA reserves to maximise the write off of our remaining deferred IS costs of £3.4m, which reduces the recovery and fees charged for 2009/10. As a result, our final ORA reserves at 31 March 2009 were £nil (2007/08: £4.5m) and our total reserves (excluding pension liability) were a deficit of £34.2m. The items that make up the total reserve deficit of £34.2m (as shown in table 5.5) reflect costs incurred that will be recovered in future years.

In our Business Plan 2007/08, we introduced two new components in the calculation of our Annual Funding Requirement, and so now hold reserves or deficits against them. They are:

- A three-year transition programme as part of our move towards more outcomes-focused regulation. At 1 April 2008 we had established reserves of £5.0m to fund the cost of that work. We plan to recover the cost of this work (which is expected to cost not more than £50m in total over the three year period) over a period of 10 years. So, during 2008/09 we raised £5.0m to fund those costs, taking the total raised to £25.2m. We incurred costs of £15.9m during the year, bringing the total incurred to £31.1m, leaving negative reserves of £5.9m at 31 March 2009.
- A £20m pension deficit reduction contribution was made in 2006/07. In 2008/09, we collected £2.5m, leaving a net prepayment of £10.2m at 31 March 2009.

In addition, scope changes (£2.5m specific to 2008/09) have been separately identified and their accumulated expenditure (£2.7m) will, in future, be recovered from appropriate fee blocks.

Further to this, as mentioned earlier, the Board approved an additional expenditure of £15.4m for SEP and Lifecycle costs, which will be recovered in 2009/10.

Movements in our reserves / (deficits) can be summarised as follows:

**Table 5.5**
**Reserves / (Deficits) movements**

| | ORA £m | SEP & Lifecycle reserve £m | Scope change & deferred IS costs £m | Outcomes focused regulation transition reserve £m | Additional pension payment £m | Total £m |
|---|---|---|---|---|---|---|
| **At 1 April 2008** | 4.5 | | (3.6) | 5.0 | (12.7) | (6.8) |
| Shortfall of revenue collected | (6.1) | (15.4) | | 5.0 | 2.5 | (14.0) |
| ORA budget not spent | 3.4 | | | | | 3.4 |
| Pension adjustments not included in statutory accounts | 1.6 | | | | | 1.6 |
| Deferred IS costs | (3.4) | | 3.4 | | | - |
| Costs relating to scope change | | | (2.5) | | | (2.5) |
| Outcomes-focused regulation transition costs incurred | | | | (15.9) | | (15.9) |
| **Total management reserves at 31 March 2009** | **-** | **(15.4)** | **(2.7)** | **(5.9)** | **(10.2)** | **(34.2)** |
| **Net pension liability** | | | | | | (88.9) |
| **Total statutory reserves at 31 March 2009** | | | | | | **(123.1)** |

| | |
|---|---|
| **Box 12**<br><br>**Financial Management and Reporting Framework** | The scope of activities falling within our remit is wide and varied. This includes some activities which are intended to be temporary in nature and/or which 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:<br>• exert sound financial management and budgetary control over all areas of our expenditure and income; and<br>• seek to manage any unavoidable volatility to minimise the impact on fee-payers from year to year.<br>Our Board believes that 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 that are subject to year-on-year management as part of our budget process. The cost of ORA is the key figure, along with explanations of any material movements, which shows how we have met our obligation to be economic and efficient in using our resources. |
| Changes in Scope (increase or decrease) | Parliament may legislate to change the scope of the 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, in the first financial year affected by the change in scope, and until the new supervisory process is fully established, we believe material activities resulting from a scope change are best controlled separately so they are individually identifiable. In the longer term, when the ongoing 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 will include the costs of exceptional items within the cost of our ORA, and will report on any material movements from year to year. |
| 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.<br><br>While 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 may seek to smooth 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 FSMA that guarantees their independence from the FSA. These bodies and the Smaller Businesses Practitioner Panel control 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. |
| Complaints Commissioner | FSMA requires that an arrangement be 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 reduce this deficit over time are inherently variable and depend on a number of 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 2019. |
| Transition costs | The changes necessary to improve the effectiveness of our people and move towards a more outcomes-focused regulatory approach will be controlled separately over a three-year period until 31 March 2010. We have set up a separate multi-year budget of £50m for that expense. |
| Reserves | In line with our Treasury Management Policy, we target ORA reserve (that is the cumulative excess of our fees over our costs) levels of £nil, plus or minus 2% of the costs of our ORA. With the exception of the pension deficit, all other reserve deficits represent costs that have been incurred that will be recovered in future years. |

| | |
|---|---|
| **FINANCIAL RISK MANAGEMENT** | In the ordinary course of business, our operations expose us to a number of financial risks including credit risk, liquidity risk, inflation risk and the risk 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 mitigating action where required. The 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.<br><br>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 and the overall management of financial risk) and by our Operations business unit (concerning the financial transaction processing cycles, for example 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 are 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 on a regular basis. |
| Liquidity, price and cash flow risk | The Board has approved a policy for the management of any surplus cash balances that we may hold above the level needed to manage our short-term liquidity requirements. Such balances are invested by our agents, until January 2007 Royal Bank of Scotland, and then Lloyds Banking Group, 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. The concentration and the return on those investments, and the identity of our counter-parties, are monitored daily.<br><br>Since January 2007, we have had a £100m revolving credit facility contract with Lloyds Banking Group, which is run alongside and operates in conjunction with the agency treasury service, allowing us to manage our net finance costs. Based on the activities in our 2009/10 Business Plan, we identified the need to extend our credit facility. Accordingly, we have recently entered into a similar revolving credit facility arrangement with HSBC for a further £100m facility. |
| Final salary pension scheme | Our most significant financial management 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 on pages 59 to 60. |
| Leases | Under the terms of the lease for our premises at 25 The North Colonnade, for the period from 4 November 2008 to 3 November 2018, the rent that we pay each year will increase in line with retail price inflation (RPI), subject to a minimum annual increase of 2.5% and a maximum of 5.0%. Given that cap and our current assumptions concerning the future levels of RPI, we do not consider it necessary to take further action to manage our potential exposure to an increase in RPI on the cost of this lease. |
| Currency risk | We do not run any significant exposure to currency risk. |

# Section six

# The Board of the Financial Services Authority

1. Adair, Lord Turner
Chairman

2. Karin Forseke
Non-executive director

3. Iain Brown
Company Secretary

4. Jon Pain
Managing Director, Retail Markets

5. Andrew Whittaker
General Counsel

6. Peter Fisher
Non-executive director

7. Hector Sants
Chief Executive

8. Brian Flanagan
Non-executive director

9. Hugh Stevenson
Deputy Chairman

10. Carolyn Fairbairn
Non-executive director

11. Professor David Miles
Non-executive director

12. Paul Tucker
Non-executive director

13. Sally Dewar
Managing Director, Wholesale and Institutional Markets

14. Michael Slack
Non-executive director


Full biographies of the Directors are available on the FSA website at: http://www.fsa.gov.uk/Pages/About/Who/Board/index.shtml

# Report of the Directors for the year ended 31 March 2009

Throughout the Directors' Report, references are made to the FSA's website. The full addresses are detailed below.

Table 6.1

| | |
|---|---|
| Financial Risk Outlook | http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2009.pdf |
| Business Plan | http://www.fsa.gov.uk/pubs/plan/pb2009_10.pdf |
| Corporate Responsibility | http://www.fsa.gov.uk/Pages/About/What/cr/index.shtml |
| Health & Safety | http://www.fsa.gov.uk/pubs/staff/staff_handbook.pdf |
| Equal Opportunities | http://www.fsa.gov.uk/pubs/staff/staff_handbook.pdf |

## Table 6.2

| Name | Board meetings | Additional Board meetings* | NedCo | RemCo | AuditCo | RiskCo | Original appointment date | Expiry of current term |
|---|---|---|---|---|---|---|---|---|
| Clive Briault[b] | 0/1 | 0/0 | | | | | 01.04.04 | 30.04.08 |
| Sir James Crosby[b & c] | 7/8 | 1/4 | 4/5 | 3/3 | 6/6 | | 15.01.04 | 11.02.09 |
| Sally Dewar | 10/10 | 5/6 | | | | | 09.01.08 | 08.01.11 |
| Carolyn Fairbairn[c] | 9/10 | 5/5 | 6/6 | | 1/1 | 4/5 | 11.12.07 | 10.12.10 |
| Peter Fisher[c] | 8/10 | 4/5 | 5/6 | | | 4/5 | 19.01.07 | 18.01.10 |
| Brian Flanagan[c] | 10/10 | 3/5 | 6/6 | 4/4 | 7/7 | | 19.01.07 | 18.01.10 |
| Karin Forseke[b & c] | 10/10 | 5/5 | 5/6 | 1/1 | 7/7 | | 01.12.04 | 30.11.10 |
| Sir John Gieve[c] | 8/9 | 3/4 | 5/5 | | | 4/4 | 16.01.06 | 28.02.09 |
| David Kenmir[b] | 10/10 | 4/6 | | | | | 01.04.04 | 31.03.09 |
| Sir Callum McCarthy | 4/4 | 2/2 | | | | | 22.09.03 | 19.09.08 |
| Professor David Miles[b & c] | 10/10 | 5/5 | 6/6 | | | 5/5 | 01.04.04 | 31.03.10 |
| Jon Pain | 6/6 | 4/5 | | | | | 08.09.08 | 07.09.11 |
| Hector Sants[b] | 10/10 | 5/6 | | | | | 04.05.04 | 19.07.10 |
| Michael Slack[b & c] | 10/10 | 4/5 | 6/6 | 4/4 | 7/7 | | 01.12.04 | 30.11.10 |
| Hugh Stevenson[a, b & c] | 10/10 | 5/5 | 6/6 | 4/4 | | 5/5 | 01.06.04 | 31.05.10 |
| Paul Tucker[c] | 1/1 | 1/1 | 1/1 | | | 1/1 | 01.03.09 | 29.02.12 |
| Adair, Lord Turner | 6/6 | 4/4 | | | | | 20.09.08 | 19.09.13 |

**Key**

a Chairman of FSA Pension Plan Trustee Ltd

b Director serving second term

c Independent non-executive director

* Additional meetings to those scheduled at the start of the year, held due to market conditions often at very short notice

### Committee membership during the year

**Audit Committee (AuditCo)**
Sir James Crosby (member until 11 February 2009)
Carolyn Fairbairn (member from 26 February 2009)
Brian Flanagan
Karin Forseke (Chair of AuditCo)
Michael Slack

**Risk Committee (RiskCo)**
Carolyn Fairbairn
Peter Fisher
Sir John Gieve (member until 28 February 2009)
Professor David Miles
Hugh Stevenson (Chair of RiskCo)
Paul Tucker (member from 1 March 2009)

**Remuneration Committee (RemCo)**
Sir James Crosby (Chair of RemCo until 11 February 2009)
Brian Flanagan
Michael Slack
Hugh Stevenson (Chair of RemCo from 6 March 2009)
Karin Forseke (member from 9 March 2009)

**Non-executive directors' committee (NedCo)**
All Non-executives are members of NedCo
Sir James Crosby (Chair of NedCo until 11 February 2009)
Hugh Stevenson (Chair of NedCo from 6 March 2009)

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.

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.

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 Code.

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

## Principal activities

The FSA is the primary regulator of financial services in the UK and has statutory responsibilities set out in FSMA. Detailed information on the FSA's principal activities for the year can be found in the first four sections of the Annual Report.

## 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 five sections of the Annual Report.

## Principal risks and uncertainties

The principal risk for the FSA is the failure to meet its statutory objectives. The key external issues that pose risks to the FSA's ability to meet its statutory objectives are explained in the Financial Risk Outlook 2009 (available on the website). All identified risks and uncertainties are kept under review throughout the organisation including at the highest level by RiskCo and AuditCo. Further information on some of the key areas recently reviewed can be found in the committees' reports.

## Development and performance of the FSA

Analysis of the FSA's performance during the year and the position at the end of the financial year are set out in the Financial Review and the financial statements for the year. Future developments of the FSA can be found in the Business Plan for 2009/10 which is available on the FSA's website and provides information relating to the FSA's budget and priorities.

## Directors' responsibilities in respect of the 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 1985. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Insofar as the directors are aware:

- there is no relevant audit information of which the company's auditors are 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 auditors are 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 United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

## Financial position

The FSA's primary source of income is the fees charged to regulated firms. Specific information on the FSA's financial position is provided in the financial statements and in the Financial Review. The Financial Review explains how the FSA manages its pensions liabilities. The directors agree with the analysis in the Financial Review and believe the FSA remains able to meet its liabilities as they fall due.

## Going concern

The directors are satisfied that the FSA has sufficient resources to continue its business for the foreseeable future and therefore the going concern basis continues to be appropriate in preparing financial statements.

## Corporate responsibility

With regard to corporate responsibility (CR), the FSA aims to be a good corporate citizen and develop projects that will both help the community and be of benefit to staff.

For the FSA to consider undertaking a CR activity it must pass one of three tests. The activity must:

- support the FSA's statutory objectives;
- make the FSA a better regulator, as defined in the FSA's principles of good regulation; or
- it must be considered best practice by the industry and be seen as appropriate for the FSA.

The FSA publishes a separate CR Report that focuses on the following key areas:

## People

The FSA aims to be a responsible and diverse employer providing an environment where employees and visitors may feel safe and free from prejudice of any nature. The FSA has policies that outlines its approach to diversity and inclusion, flexible working, career development, and wellbeing. Each of these emphasise the FSA's commitment to its people. The FSA has key performance indicators which focus on these areas. Performance, where possible, is measured and reported in the CR section of the website. The FSA continues to seek appropriate measures for those areas that are not currently assessed.

## Environment

The FSA is conscious of the impact of its operations on the environment and the increasing expectations that organisations should manage these impacts. The FSA aims to reduce $CO_2$ emissions, energy use, water use and the waste it produces, as well as increase the amount of that waste that is recycled. In order to achieve these aims the FSA seeks to raise awareness of environmental issues among its staff. The FSA sets targets in each of our key impact areas, and these are measured and reported on in the CR section of our website.

## Community

The FSA strives to have a positive impact on society. It encourages, supports and enables staff to play an active role in the local community near its headquarters. Key performance indicators assess the numbers of employees involved in volunteering and the number of community recipients of the FSA's various projects. Staff are encouraged to view volunteering as a part of their personal development and, to facilitate that, all applications for volunteering are now put through the FSA's internal learning and development booking system.

## Charitable donations

The FSA made the donations shown in Table 6.3 as part of its community affairs programme.

## Health & safety

The FSA is committed to providing a healthy and safe environment for all staff and visitors. It pursues a policy to promote health and safety at work and seeks the co-operation of all employees and visitors in this endeavour.

## Equal opportunities

The FSA values inclusiveness and confirms its continuing commitment to the principles of equal opportunities in employment, and in all the activities it undertakes. It endeavours to ensure that all members of staff, visitors and applicants are treated on the basis of their merits and abilities and that no-one suffers discrimination or disadvantage regardless of gender, race, disability, sexual orientation, religious belief or age.

In accordance with the Disability Discrimination Act 2005 and the amended Sex Discrimination Act 1975 the FSA works to eliminate unlawful discrimination and harassment and promote both disability equality and equal opportunities between men and women.

## Employee involvement

A variety of media is used to communicate with employees, including the intranet, email, forums and staff meetings. Employees are invited to give feedback on the FSA and its operations both informally and formally, through an annual staff survey.

### Table 6.3

| Recipient | Amount | Reason |
|---|---|---|
| Crisis | £8,300 | In lieu of producing a Christmas card |

The Staff Consultative Committee (SCC) is the forum through which the FSA complies with the EU Information and Consultation Directive 2004. The SCC also provides a clear channel of communication and consultation between the FSA and its 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. The FSA recognises 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 5.4 days training (average of 4.5 days training in 2007/08). It is likely that this has increased as a result of the SEP which included focus on training supervisory staff (an overview of SEP is provided in section 1).

## Supplier payment policy

The FSA's policy is to aim to pay 90% of invoices within 30 days of receipt of the invoice. The average time taken to pay suppliers from receipt of invoice was 30 days. The FSA aims to pay all small suppliers within ten days from receipt of invoice.

## Auditors

A resolution to reappoint Grant Thornton UK LLP as auditors of the company will be proposed at a General Meeting in July 2009.

By Order of the Board

K Iain Brown
Secretary

28 May 2009

# Corporate governance statement and remuneration report

## Corporate governance statement for the year ended 31 March 2009

### Table 6.4

| | |
|---|---|
| Accountability mechanisms | http://www.fsa.gov.uk/Pages/About/Who/Accountability/index.shtml |
| Role of chairman | http://www.fsa.gov.uk/pages/About/Who/Management/Chairman.shtml |
| Role of chief executive | http://www.fsa.gov.uk/pages/About/Who/Management/CEO.shtml |
| Schedule of matters reserved to the Board | http://www.fsa.gov.uk/pubs/other/SoM.pdf |
| Board delegations including terms of reference of the committees | http://www.fsa.gov.uk/pubs/other/Gov_memo.pdf |
| Directors' biographies | http://www.fsa.gov.uk/Pages/About/Who/board/index.shtml |
| NedCo, RemCo, AuditCo and RiskCo membership | http://www.fsa.gov.uk/Pages/About/Who/board/committees/index.shtml |
| Regulatory Decisions Committee membership | http://www.fsa.gov.uk/Pages/About/Who/board/committees/RDC/index.shtml |
| Listing Authority Advisory Committee | http://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 Combined Code on Corporate Governance (the Code). However, the Board is committed to meeting high standards of corporate governance and has decided that the FSA should comply with the Code as far as appropriate. This report seeks to explain where the FSA complies with the principles in the Code.

FSMA requires that the FSA has a number of accountability mechanisms which include holding an Annual Public Meeting and the requirement to report on the extent to which regulatory objectives have been met.

The FSA operates independently of government, but is accountable to Parliament through Treasury ministers. The FSA is required to consult on its rules and general policy with consumers and practitioners and it does so through the Consumer, Practitioner and Smaller Businesses Practitioner Panels. More information about the accountability mechanisms can be found on the website.

A unitary Board leads the FSA and approves the company's strategy and 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 the 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. FSMA requires that there is a non-executive directors' committee (NedCo), which keeps certain functions under review. Information on its work is set out in the Report of the non-executive directors.

The Board meets regularly. Details of the number of Board and committee meetings held this year and attendance at those meetings are set out in Table 6.2. The membership of the various committees can also be found in Table 6.2 and on the website.

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

The non-executive directors of the Board have a variety of skills and experience that are appropriate for the requirements of the company. Notwithstanding 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 company. 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 taken without undue influence. The Board members also adhere to a code of conduct, which was reviewed during the year.

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 in advance of circulation to Board members to ensure that information is accurate and clear. Papers are usually circulated one week before meetings.

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

Directors of the FSA are formally appointed by the Treasury, following a rigorous selection process. Although 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 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 year this included papers for information and presentations on Treating Customers Fairly, Financial Crime and Banking Regulatory Policy Framework.

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

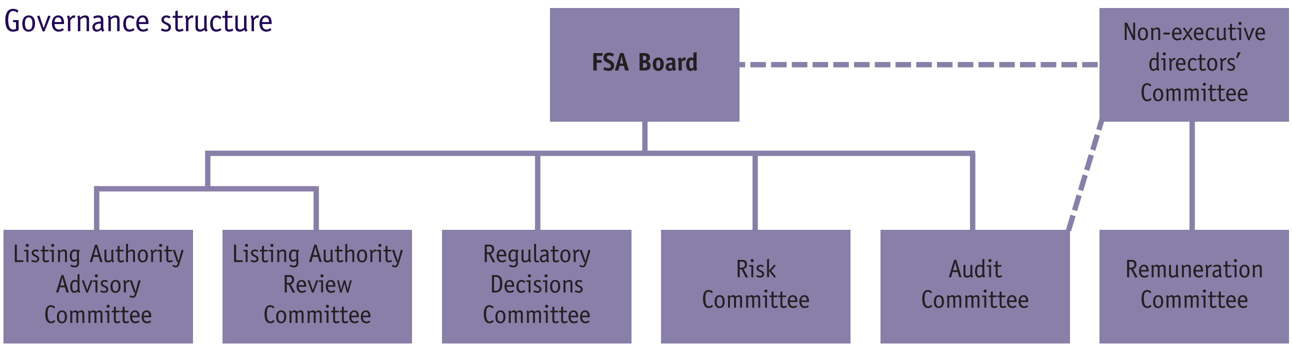
Due to its statutory nature, the FSA benefits under FSMA from immunity in respect of legal action, which it supplements with indemnities in favour of individual directors. The Board therefore regards insurance in respect of legal action against directors as unnecessary.

## Evaluations

Due to the change of chairman which took place during the course of year, the Board considered and decided not to undertake a full review of the effectiveness of the Board and its committees for 2008/09. The Board considered the recommendations of the evaluations that took place during 2007/08 with the previous chairman and some recommendations were deferred as being dependent on input from the incoming chairman. A further review of the evaluation was undertaken with the current chairman and some further recommendations were implemented. The Board will review its performance as normal in future.

The current chairman follows the practice of the previous chairman of meeting regularly with each director and discussing their individual contribution to the Board. During the year, and led by the senior independent director, the non-executives met without the current chairman present to appraise his performance.

## Governance structure



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

NedCo operates in line with the provisions of Schedule 1 to FSMA. Members of NedCo received reports in respect of Board committees and the Remuneration Committee (RemCo is a sub-committee of NedCo) and met together on six occasions during the year to ensure that its statutory functions were being satisfactorily discharged by:

- reviewing reports on efficient and economic use of the FSA's resources;
- receiving reports on AuditCo work in keeping under review the question of whether the FSA's internal financial controls secured the proper conduct of its financial affairs;
- receiving reports from RemCo on the remuneration awards to the executive directors and the chairman; and the performance-related bonus payments made to the executive directors;
- receiving reports from RemCo on its review of the priorities and focus of the executive directors' objectives and approving those objectives; and
- receiving reports from RemCo on its oversight of the development and implementation of a revised remuneration strategy.

NedCo's composition is shown in Table 6.2. Further details on the statutory functions it discharges can be found on the FSA website.

## Report of the non-executive directors

The unitary Board (which includes all non-executive directors) is the FSA's primary decision-making body. It also exercises a broad oversight of all the FSA's policy, strategic and operational activities. The extent of the Board's role and the provision of timely and relevant information to the Board, its committees and NedCo, 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 kept under review whether the FSA is using its 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 is reviewed specifically by NedCo. NedCo challenged information provided to it and sought further explanations when appropriate. NedCo also encouraged enhancements to the reporting framework on a continuous improvement basis.

### Internal financial controls

During the year, NedCo has kept under review the question of whether the FSA's internal financial controls secure the proper conduct of its financial affairs, in conjunction with AuditCo, which is a Board committee. The full statement on internal controls includes information on financial controls and is on page 81.

### 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.

## Remuneration Committee (RemCo)

The composition of RemCo is provided in Table 6.2. The functions and terms of reference of RemCo can be found on the website.

# Remuneration report

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

Information on the appointment of the chairman and the executive directors can be found in the Report of the Directors and in the remuneration Table 6.9. The executive directors have continuous contracts of employment that provide for 12 months' prior notice of termination by either party. The chairman is employed on a fixed-term contract which commenced on 20 September 2008 and ends on 19 September 2013 (but also contains provision for 12 months' notice).

During the financial year RemCo reviewed and oversaw the development of a revised reward strategy for FSA employees. The strategy is based on the philosophy of:

- ensuring competitive and market aligned total remuneration;
- providing fair and transparent links between skills, contribution and reward;
- promoting a performance orientated culture that rewards top performers; and
- ensuring a more equitable distribution of reward spend.

RemCo approved the departure terms of Sir Callum McCarthy and David Kenmir.

Sir Callum's fixed-term contract ended on 19 September 2008. Under its terms Sir Callum was prevented from engaging in similar activities for a period of between three and six months after that date. The contract provided for payments in respect of the initial three-month period of restriction and for payments for any further period of restriction at the discretion of RemCo. RemCo considered it to be in the interests of the FSA to impose a total restriction on Sir Callum of six months and approved payments for the additional period.

In August 2008, David Kenmir, who was then Acting Managing Director, Retail Markets, indicated his intention to leave the employment of the FSA. However, following the appointment of a new Managing Director, Retail Markets, and at the request of the FSA, Mr Kenmir agreed to resume his duties as Chief Operating Officer until a new Chief Operating Officer had been recruited and was in post. Mr Kenmir resigned as a director on 31 March 2009. As with other executive directors, his contract protects the FSA by preventing him from engaging in similar activities for a period of six months following his departure, during this period salary and benefits totalling £189,206 will be payable to Mr Kenmir. As part of the agreement under which Mr Kenmir resumed his duties as Chief Operating Officer, RemCo approved the payment to him, upon the expiry of the six month restriction on 30 September 2009, of a sum equivalent to his salary and benefits for the balance of his 12-month notice period - amounting to £186,540 plus a bonus of £15,000 (assessed by reference to the completion of specific objectives for the period 1 January to 31 March 2009) and sundry costs of £14,000. These payments appear in the Table of Directors' emoluments on page 79 under compensation for loss of office.

Sir James Crosby resigned as Chairman of NedCo, Deputy Chairman and as a non-executive director on 11 February 2009. No payment of compensation for loss of office was made.

One of the responsibilities of RemCo is to determine the remuneration of the executive directors. In doing this, their performance was evaluated and included assessment of performance against objectives. The objectives for each director related to achievement of the FSA's collective FSMA objectives by reference to the Business Plan, objectives relating to the directors' individual areas of responsibility and their leadership abilities. In reaching its decisions, RemCo had the benefit of advice from the Director, Human Resources, together with market data from Watson Wyatt, its external consultants.

The total remuneration package of the executive directors comprises four elements which are common to other FSA employees.

### Table 6.5

| Director | Sir Callum McCarthy | Hector Sants | Sally Dewar | Jon Pain | David Kenmir |
|---|---|---|---|---|---|
| Flexible account (£) | 22,151 | 28,737 | 18,996 | 13,658 | 20,280 |

- Basic pensionable salary

Salaries are reviewed annually. In setting base salaries for the chairman and the executive directors, RemCo aimed, so far as possible, to position them at or around the median market level applying in the private sector.

- Performance-related bonus

The executive directors are eligible to be considered for a performance-related bonus up to a maximum of 35% of base pensionable salary. The chairman is not eligible to be considered for a bonus. In reaching decisions on bonuses, RemCo took proper account of all aspects of the FSA's and the individual's performance. In particular, RemCo supported the publicly stated view of both the chairman and chief executive that it was appropriate to pay bonuses to individual employees in the FSA, whether executive directors or otherwise. The FSA operates its remuneration structure by way of total compensation, an element of which is a personal incentive plan related to individual performance. It was appropriate for the very significant efforts made by FSA employees during the last year to be rewarded in a way that reflected individual performance.

Mr Sants was awarded a bonus of £130,000 for 2008. However, in view of the wider public debate relating to levels of bonuses payable in the financial services industry and the role of the FSA in seeking to reach conclusions on its regulatory approach to the issue, Mr Sants declined to accept the award.

- Other benefits

A sum is available for each employee which may be spent against a range of benefits. The sum for the chairman and executive directors is shown in Table 6.5. The chairman and executive directors also have access to a car and driver and an appropriate portion of these costs is included in "other emoluments" in Table 6.9.

- Pensions

The FSA Pension Plan (the Plan) has two sections, both of which are non-contributory: a defined benefit section (closed to new entrants) and a defined contribution section. David Kenmir and Sally Dewar are members of the defined contribution section. Before he was appointed as a Managing Director, Mr Kenmir was a member of the defined benefit section and has retained deferred benefits in that section. Sir Callum McCarthy was not a member of the Plan, but was contractually entitled to receive a non-pensionable supplement to his base salary in lieu as with all FSA employees. Adair, Lord Turner, Hector Sants and Jon Pain are not members of the Plan and are also entitled to receive a non-pensionable supplement. The sums paid to the chairmen (former and current) and each of the executive directors, in respect of each component, are shown in Table 6.9.

## Non-executive directors

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 April 2008 the Panel reviewed the fees payable; the Panel increased the fees for non-executive directors, chairs of Board Committees and the chairman of the FSA Pension Plan Trustee Limited as shown in the notes to Table 6.9.

## Emoluments tables

This section of the report, contains audited information on directors' emoluments.

At the end of the year, a deferred defined benefits pension was held in the Plan for one executive director as a result of their active membership in the defined benefit section of the Plan up to 1 April 2004. From 1 April 2004 the executive director joined the defined contribution section of the plan. Details of accrued benefits in the defined benefit section are set out in Table 6.6.

### Table 6.6

| | **Accrued pension at 31 March 2008 £'000** | **Real increase/(decrease) in accrued pension £'000** | **Inflation £'000** | **Accrued pension at 31 March 2009 £'000** |
|---|---|---|---|---|
| David Kenmir | 56 | - | 3 | 59 |

Table 6.7 sets out the transfer values of those directors' benefits under the scheme, which are calculated in a manner consistent with 'Retirement Benefit Schemes – Transfer Values (GN11)' published by the Institute of Actuaries.

### Table 6.7

| | **Transfer value at 31 March 2008 £'000** | **Transfer value of real increase in accrued pension £'000** | **Other changes to transfer value £'000** | **Transfer value at 31 March 2009 £'000** |
|---|---|---|---|---|
| David Kenmir | 493 | - | 265 | 758 |

Note: The transfer methodology for the Final Salary Section of the FSA Pension Plan was updated in December 2008 in order to comply with the Occupational Pension Schemes (Transfer Values)(Amendment) Regulations which took effect from 1 October 2008. These regulations set a minimum level for transfer value calculations based upon 'best estimate' assumptions. This change was adopted by the Trustee during the year and was unrelated to David Kenmir's departure.

Members of the Plan have the option to pay additional voluntary contributions; neither contributions nor the resulting benefits are included.

During the year, payments were made into the defined contribution section of the pension scheme for two executive directors – these payments are set out in Table 6.8.

### Table 6.8

| Director | Sally Dewar | David Kenmir |
|---|---|---|
| Pension contributions into the defined contribution section of the pension scheme – £'000 | 35 | 38 |

## Table 6.9

| | Board fee | Salary | Performance related bonuses | Other emoluments and benefits | Compensation for loss of office: Salary & benefits for six months period of purdah | Compensation for loss of office: Other | 2009 Total | 2008 Total |
|---|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ | £ |
| Sir Callum McCarthy[1] | - | 405,332 | - | 81,906 | - | - | 487,238 | 480,553 |
| Adair, Lord Turner (Chairman)[1] | - | 219,200 | - | 27,346 | - | - | 246,546 | - |
| **Executive Directors** | | | | | | | | |
| Clive Briault | - | - | - | - | - | - | - | 883,711 |
| Sally Dewar | - | 290,000 | 55,000 | 90,179 | - | - | 435,179 | 71,667 |
| David Kenmir[3] | - | 315,000 | 55,000 | 25,613 | 189,206 | 215,540 | 800,359 | 399,003 |
| Jon Pain[4] | - | 240,289 | 30,000 | 42,000 | - | - | 312,289 | - |
| Hector Sants[2] | - | 478,000 | - | 145,170 | - | - | 623,170 | 661,948 |
| John Tiner | - | - | - | - | - | - | - | 445,621 |
| **Non-executive Directors**[5] | | | | | | | | |
| Dame Deirdre Hutton CBE | - | - | - | - | - | - | - | 45,692 |
| Sir James Crosby[6] | 63,250 | - | - | - | - | - | 63,250 | 42,726 |
| Carolyn Fairbairn | 28,000 | - | - | - | - | - | 28,000 | 8,154 |
| Peter Fisher[8] | - | - | - | - | - | - | - | - |
| Brian Flanagan | 28,000 | - | - | - | - | - | 28,000 | 26,500 |
| Karin Forseke[7] | 36,500 | - | - | - | - | - | 36,500 | 30,500 |
| Sir John Gieve[8] | - | - | - | - | - | - | - | - |
| Professor David Miles | 28,000 | - | - | - | - | - | 28,000 | 26,500 |
| Michael Slack | 28,000 | - | - | - | - | - | 28,000 | 26,500 |
| Hugh Stevenson[6,7,9] | 58,716 | - | - | - | - | - | 58,716 | 53,500 |
| Paul Tucker[10] | - | - | - | - | - | - | - | - |
| | 270,466 | 1,947,821 | 140,000 | 412,214 | 189,206 | 215,540 | 3,175,247 | 3,202,575 |
| Of which fees for service as Directors | | | | | | | 270,466 | 260,072 |
| Remuneration as executives | | | | | | | 2,904,781 | 2,942,503 |
| | | | | | | | 3,175,247 | 3,202,575 |

1 Sir Callum McCarthy's term of office as chairman came to an end on 19 September 2008. Further information on his departure terms is set out on page 76. Adair, Lord Turner was appointed as chairman from 20 September 2008.

2 The total emoluments of the highest paid director during the year, Hector Sants, were £623,170 (2008: £661,948). Other benefits include £50,851 (2008: £45,438) paid during the year towards the funding of his personal pension, and amounts for car and flexible benefits. Hector Sants was awarded a bonus of £130,000 for 2008. Mr Sants declined to accept the award.

3 David Kenmir resigned as a director on 31 March 2009. The FSA has provided fully in its accounts for the sums which fall to be paid to Mr Kenmir during 2009. The sum under compensation for loss of office comprises a total of £189,206 for the period to 30 September 2009 during which Mr Kenmir's activities are restricted and £215,540 in respect of the balance of his notice period. Further information on Mr. Kenmir's departure terms is set out on page 76.

4 Jon Pain was appointed as an Executive Director from 8 September 2008.

5 The fee for a non-executive director was set by the independent panel, established with the approval of HMT, at £28,000 per annum with effect from 1 April 2008.

6 Sir James Crosby resigned as a director, Chair of NedCo and Deputy Chairman on 11 February 2009. Hugh Stevenson was appointed Chair of NedCo on 6 March 2009 and Deputy Chair on 26 March 2009. The fee payable to the Deputy Chairman was set by the independent panel at £69,000 per annum.

7 An additional fee of £8,500 per annum is paid to any non-executive director (other than the Deputy Chairman) who has been appointed to chair a committee of the Board. Hugh Stevenson and Karin Forseke chaired the Risk Committee and Audit Committee, respectively, throughout the year.

8 Sir John Gieve and Peter Fisher both waived their Board fee in respect of the years concerned. Sir John Gieve resigned as a director with effect from 28 February 2009.

9 Hugh Stevenson also chaired the Board of the FSA Pension Plan Trustee Ltd in the year. The annual fee was set by the independent panel at £20,000 with effect from 1 April 2008.

10 Paul Tucker was appointed as a non-executive director from 1 March 2009. He has waived his Board fee for the year.

## Committees of the Board

### Audit Committee (AuditCo)

#### Membership

The composition of AuditCo (including changes to membership in the year) is shown in Table 6.2. AuditCo's members have considerable financial and commercial experience.

#### Meetings

AuditCo met on seven occasions during the year. The chief operating officer, the director, internal audit and the lead audit partner from Grant Thornton UK LLP (GTUK) attended each of the scheduled meetings at the request of the committee chair. Private sessions were held with the internal auditor, the external auditor and AuditCo without management present throughout the year.

#### Role and responsibilities

The role of AuditCo is to advise the board on:

- the robustness of internal financial controls;
- the effectiveness of the internal controls used by the executive to manage the FSA's internal risks;
- the statements in the annual accounts that relate to financial controls and internal risks; and
- compliance with the Combined Code.

To discharge its functions AuditCo has:

- reviewed the integrity of the financial statements and provided challenge to management on financial performance;
- reviewed the financial reporting judgements and disclosure issues;
- reviewed the treasury management policy;
- reviewed compliance by FSA staff with key internal policies and procedures;
- reviewed and challenged identification of internal risks including financial management risks, information systems risk and people risks (as reflected in the Risk Dashboard and management information) and management's mitigation of these risks;
- reviewed the adequacy and effectiveness of the internal audit function which was supported by the work of an external consultant;
- reviewed and approved the Audit Universe and the audit plan for Internal Audit;
- reviewed the quarterly reports from Internal Audit;
- reviewed FSA's whistleblowing policy;
- reviewed potential and actual litigation against the FSA;
- reviewed the chairman's expenses for the year;
- initiated a review of the arrangements for the Pension Plan;
- reviewed AuditCo's effectiveness and strategy; and
- reviewed AuditCo's terms of reference to ensure that they remained fit-for-purpose.

AuditCo's terms of reference can be found on the FSA's website.

#### External auditor

The FSA's external auditors GTUK were appointed in 2007, following the merger with RSM Robson Rhodes LLP who were appointed in 2005, following a rigorous selection process. AuditCo recommended and the Board accepted that a re-tendering exercise was unnecessary. The lead audit partner was appointed in 2007. A new lead audit partner will be appointed at least every five years and managers are rotated every seven years. No partner or staff from GTUK are connected to the FSA's auditor or may transfer to the authority. AuditCo reviewed the auditor's terms of engagement and remuneration and recommended to the Board that the GTUK are re-appointed for the year.

AuditCo reviewed the quality reliability, independence and effectiveness of the external auditor. The FSA safeguards the external auditor's objectivity and independence through its policy which requires that fees for non-audit services are limited to the charge for performing the audit of the FSA's annual accounts. Information on fees paid to the auditor is provided on page 97.

### Risk Committee (RiskCo)

RiskCo's purpose is to assist the Board in reviewing 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, and information on its membership, can be found on the FSA's website. Information on the Committee members' attendance at meetings can be found in Table 6.2.

The FSA Executive's risk management and reporting system records all risks identified and reviewed by local business areas. The risks are further reviewed and appropriate mitigation strategies are put in place by the Executive.

RiskCo has responsibility for review and oversight of the risks to the FSA's statutory objectives, the 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 made use of the Executive's risk management and reporting system. RiskCo has sought assurance 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 by the Executive;
- whether the actions taken to address and mitigate the risks are effective; and
- whether the timescales for mitigation are 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 into the risk management system as required.

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

- the implications of the economic downturn on regulation and regulated firms, including the effect on stress testing for firms;
- the sustainability of business models in the financial services sector;
- international crisis management effectiveness;
- loss of confidence in the regulation of financial institutions;
- the translation of the risks identified in the Financial Risk Outlook into supervision practice;
- the completion of the treating customers fairly project;
- the impact of movement in the valuation of credit risk on insurance companies;
- downgrades in ratings of monoline insurers; and
- counterparty exposure to emerging markets.

## Internal controls

The Board and NedCo (the latter under FSMA) have responsibility for ensuring the FSA has 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 management on financial, operational and compliance controls and the risk management systems. In addition, it received and reviewed reports from the Director of Internal Audit summarising work undertaken, recommendations and actions by management.

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

The FSA's 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 the FSA's internal control system include the following:

- The Risk Dashboard which includes a comprehensive picture of the key internal (and regulatory) risks faced. This facilitates discussion on the best course of action to mitigate the key risks and assists senior management in taking decisions on priorities and resource allocation. This is regularly reviewed by OpCo and ExCo and formally reported to AuditCo on a quarterly basis.
- Internal Audit provides independent assurance to the FSA Board and management on the effectiveness of risk management and controls over all of the FSA's activities.
- The Audit Universe contains all the FSA's processes, systems, business projects and IS projects and programmes. Each unit within the universe has been assessed in order to appropriately prioritise review by Internal Audit and these priorities are revised periodically. Factors considered include risk, business criticality and materiality.
- The effectiveness of the Internal Audit function is reviewed on an annual basis. This is conducted by an external party every third 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.
- Defining roles and responsibilities to ensure that there is clear segregation of the regulatory aspects of the FSA's 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 the FSA 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 the FSA's website).
- Directors' and senior management's commitment to maintaining an appropriate control culture across the FSA which is regularly communicated to all staff.
- The performance management framework includes the setting of objectives on an annual basis and a formal appraisal process.

## Regulatory Decisions Committee (RDC)

The RDC takes those enforcement, authorisation and supervisory decisions that are of material significance for the firms and individuals concerned. 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 the FSA website.

## Listing Authority Committees

The Board has two listing committees made up of external practitioners to advise the Board and review elements of the FSA's function as the competent authority for listing in the UK. The Listing Authority Advisory Committee (LAAC) met three times during the year, with smaller sub-groups meeting more frequently 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 the FSA website.

# Independent auditors' report to the members of the Financial Services Authority

We have audited the financial statements of the Financial Services Authority for the year ended 31 March 2009 which comprise the income statement, the statement of recognised income and expense, the balance sheet, the statement of cash flows and related notes 1 to 21. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Corporate Governance Statement regarding directors' remuneration that is described as having been audited.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

## Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the part of the Corporate Governance Statement regarding directors' remuneration to be audited, and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Corporate Governance Statement regarding directors' remuneration to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Corporate Governance Statement regarding directors' remuneration to be audited are properly prepared in accordance with the Companies Act 1985. We report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes the specific information presented in the Financial Review that is cross referred from the Business Review section of the Directors' report.

In addition, we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report, the unaudited part of the Corporate Governance Statement, the Chairman's Statement and the Financial Review. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

## Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Corporate Governance Statement regarding directors' remuneration to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Corporate Governance Statement regarding directors' remuneration to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Corporate Governance Statement regarding directors' remuneration to be audited.

Grant Thornton UK LLP
Chartered Accountants and
Registered Auditors

London, England
28 May 2009

## Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of affairs of the company as at 31 March 2009 and of its deficit for the year then ended.
- The financial statements and the part of the Corporate Governance Statement regarding directors' remuneration to be audited have been properly prepared in accordance with the Companies Act 1985.
- The information given in the Directors' Report is consistent with the financial statements.

## Separate opinion in relation to IFRS

As explained in Note 2, the company, in addition to applying the IFRS adopted by the European Union has also complied with the IFRS as issued by the International Accounting Standards Board.

In our opinion the financial statements give a true and fair view, in accordance with IFRS, of the state of the company's affairs as at 31 March 2009 and of its deficit for the year then ended.

# Financial statements for the year ended 31 March 2009

## Income statement for the year ended 31 March 2009

| | Notes | 2009 £m | 2008 £m |
|---|---|---|---|
| Administrative costs | | (369.3) | (332.7) |
| Interest on bank deposits | | 3.2 | 5.7 |
| Other net finance (cost)/income | 15 | (1.9) | 1.8 |
| Other revenue | 7 | 21.5 | 20.5 |
| **Net costs for year** | | **(346.5)** | **(304.7)** |
| Fee revenue | | 324.4 | 303.3 |
| **Deficit before taxation** | **5** | **(22.1)** | **(1.4)** |
| Taxation | 8 | (0.9) | (1.7) |
| **Deficit after taxation** | | **(23.0)** | **(3.1)** |

All results are derived from continuing operations.

## Statement of recognised income and expense for the year ended 31 March 2009

| | Notes | 2009 £m | 2008 £m |
|---|---|---|---|
| Deficit for the year | | (23.0) | (3.1) |
| Actuarial gains and losses for the year in respect of the defined benefit pension scheme | 15 | (1.7) | (13.9) |
| **Total recognised income and expense for the year** | | **(24.7)** | **(17.0)** |

# Balance sheet as at 31 March 2009

| | Notes | 2009 £m | 2008 £m |
|---|---|---|---|
| **Non current assets** | | | |
| Intangible assets | 9 | 39.8 | 31.3 |
| Property, plant and equipment | 10 | 57.0 | 41.0 |
| | | **96.8** | **72.3** |
| Current assets | | | |
| Trade and other receivables | 11 | 17.5 | 13.7 |
| Cash and cash equivalents | 11 | 0.2 | 24.8 |
| | | **17.7** | **38.5** |
| **Total assets** | | **114.5** | **110.8** |
| **Current liabilities** | | | |
| Trade and other payables | 12 | (131.5) | (103.1) |
| Current tax liabilities | | (0.5) | (0.9) |
| Borrowings | 13 | (2.0) | - |
| | | **(134.0)** | **(104.0)** |
| **Total assets less current liabilities** | | **(19.5)** | **6.8** |
| **Non current liabilities** | | | |
| Trade and other payables | 12 | (14.6) | (13.3) |
| Long term provisions | 14 | (0.1) | (0.3) |
| **Net liabilities excluding retirement benefit obligation** | | **(34.2)** | **(6.8)** |
| Retirement benefit obligation | 15 | (88.9) | (91.6) |
| **Net liabilities, including retirement benefit obligation** | | **(123.1)** | **(98.4)** |
| **Accumulated deficit** | **16** | **(123.1)** | **(98.4)** |

The financial statements were approved and authorised for issue by the Board on 28th May 2009, and were signed on its behalf by:

Adair, Lord Turner........................ Chairman

Hector Sants........................ Chief Executive Officer

# Statement of cash flows for the year ended 31 March 2009

| | Notes | 2009<br>£m | 2008<br>£m |
|---|---|---|---|
| **Net cash generated from operations** | **21** | **12.8** | **27.0** |
| Corporation tax paid | | (1.3) | (1.6) |
| **Net cash from operating activities** | | **11.5** | **25.4** |
| **Investing activities** | | | |
| Interest received on bank deposits | | 3.2 | 5.7 |
| Expenditure on software development | 9 | (14.8) | (23.8) |
| Purchases of property, plant and equipment | 10 | (26.5) | (32.2) |
| Sale of trading investments | | - | 1.9 |
| **Net cash used in investing activities** | | **(38.1)** | **(48.4)** |
| **Returns on investment and servicing of finance** | | | |
| Proceeds from borrowings | | 2.0 | - |
| **Net decrease in cash and cash equivalents** | | **(24.6)** | **(23.0)** |
| | | | |
| **Cash and cash equivalents at the start of the year** | | **24.8** | **47.8** |
| **Cash and cash equivalents at the end of the year** | | **0.2** | **24.8** |

# Notes to the financial statements – 31 March 2009

## 1. General FSA information

The FSA is a company incorporated in the UK under the Companies Act 1985. The address of the registered office is given on page 2. The nature of the Authority's operations and its principal activities are set out on page 70.

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

At the date of the approval of these financial statements, the following Standards and Interpretations which have not been applied in these financial statements were in issue but not yet effective:

- IAS 1 Presentation of Financial Statements (revised 2007) (effective 1 January 2009)
- IAS 23 Borrowing Costs (revised 2007) (effective 1 January 2009)
- Amendment to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation (effective 1 January 2009)
- IAS 27 Consolidated and Separate Financial Statements (Revised 2008) (effective 1 July 2009)
- Amendment to IFRS 2 Share-based Payment – Vesting Conditions and Cancellations (effective 1 January 2009)
- Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements - Costs of Investment in a Subsidiary, Jointly Controlled Entity or Associate (effective 1 January 2009)
- Amendment to IAS 39 Financial Instruments: Recognition and Measurement – Eligible Hedged Items (effective 1 July 2009)
- Amendment to IFRS 7 Financial Instruments: Disclosures – Improving Disclosures About Financial Instruments (effective 1 January 2009)
- Embedded Derivatives - Amendments to IAS 39 and IFRIC 9 (effective for annual periods ending on or after 30 June 2009)
- Improvements to IFRSs (effective 1 January 2009 other than certain amendments effective 1 July 2009)
- IFRS 3 Business Combinations (Revised 2008) (effective 1 July 2009)

- IFRS 8 Operating Segments (effective 1 January 2009)
- IFRIC 13 Customer Loyalty Programmes (IASB effective date 1 July 2008)
- IFRIC 15 Agreements for the Construction of Real Estate (effective 1 January 2009)
- IFRIC 16 Hedges of a Net Investment in a Foreign Operation (effective 1 October 2008)
- IFRIC 17 Distributions of Non-cash Assets to Owners (effective 1 July 2009)
- IFRIC 18 Transfers of Assets from Customers (effective prospectively for transfers on or after 1 July 2009)

It is considered that, with the exception of IAS1 Presentation of Financial Statements and IFRS 8 Operating Segments, which affect disclosure and not the financial information or accounting policies, these do not apply to the company.

## 2. Significant accounting policies

The Financial Statements have been prepared on an historical cost basis, except for financial assets which are held at fair value. The Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS). The financial statements have also been prepared in accordance with IFRS as adopted by the European Union. The principal accounting policies adopted are set out below:

*a. Income statement*

The format of the income statement on page 85 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.

*b. Revenue recognition*

All fee 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 so as to match revenue to the cost of delivering the relevant services we provide which includes fees for applications, transaction reporting, publications and training services.

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

*c. Property, plant and equipment*

Property, plant and equipment is stated at cost less accumulated depreciation and any accumulated 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 | Up to ten years |
| Computer equipment (excluding software) | Up to three years |
| Furniture and equipment | Up to ten years |

If events or changes in circumstances indicate the carrying value may not be recoverable then the carrying values of tangible fixed assets 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 income statement.

*d. Recognition of enforcement expenses*

All costs incurred to the end of the year are included in the accounts, 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. Provision is 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. The amount provided is discounted to present value.

*e. Retirement benefit costs*

The company operates an occupational pension scheme, the FSA Pension Plan, for its employees. There are two sections in the Plan: the Final Salary section (a defined benefit arrangement which is closed to new members) and the Money Purchase section (a defined contribution arrangement for new entrants).

Defined benefit scheme – the charge to the income statement is the current service, past service, and interest costs of the scheme liabilities, less the expected return on the scheme's assets.

Defined contribution scheme – payments to the defined contribution section are recognised as an expense in the income statement, as they fall due.

The obligation in respect of the defined benefit pension scheme represents the present value of future benefits owed to employees in return for their service in the current and prior periods. The discount rate used to calculate 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.

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.

The net liabilities of the defined benefit scheme are calculated by deducting the fair value of the scheme's assets from the present value of its obligations, and disclosed as a non-current liability on the balance sheet.

Actuarial gains and losses arising in the defined benefit scheme (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 recognised income and expense in the period in which they are incurred.

*f. Financial penalties received*

Under the FSMA, the FSA has the power to levy financial penalties but it is required to apply those penalties for the "benefit of its fee-payers" which means that though the penalty payments are collected by the FSA, the FSA have no rights to recognise these amounts as revenue. If the FSA were to cease activities, then penalties held at that time would be payable to fee-payers. Accordingly, any remaining balance is then included 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 relevant fee-block in the following financial year.

*g. 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.

Rentals payable under operating leases are charged to the income statement 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.

*h. Intangible assets*

Costs associated with the development of software for internal use are capitalised only if the design of the software is technically feasible, and the FSA has both the resources and intent to complete its development and 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 income statement. 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 income statement when incurred.

*i. Impairment of tangible and intangible assets*

At each balance sheet date, the FSA reviews the carrying value of its tangible 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 fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and risks to the specific asset for which the estimates of future cash flows have not been adjusted. 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.

*j. Financial instruments*

*Trade receivables* – 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 income statement 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* – Trade payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

*Cash and cash equivalents* – Cash and cash equivalents comprise cash in hand, demand 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.

*Financial guarantee contracts* – Financial guarantee contracts are initially recognised at fair value. Subsequently, they are measured at the higher of an amount determined in accordance with IAS 37 'Provisions, contingent liabilities and contingent assets', and the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 'Revenue'.

The company's financial risk management policy is disclosed in Box 12.

*k. Provisions*

Provisions are recognised when the FSA has a present obligation as a result of a past event, and it is probable that the FSA will be required to settle that obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date and are discounted to present value where the effect is material.

*Legal challenges* – On occasion, legal proceedings are threatened or initiated against the FSA. The FSA provides for the estimated full cost of any such challenges where at the end of the year it is more likely than not that there is an obligation to be settled. The amount provided is discounted to present value where the effect is material.

*l. Taxation*

The tax expense represents the sum of tax currently payable.

## 3. Critical accounting judgements and key sources of estimation uncertainty

*Critical judgements in applying the Authority's accounting policies*

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

- Intangible assets – under IAS 38, internal software development costs of £14.8m (2008: £23.8m) have been capitalised. Internally developed software is designed to help the Authority carry out its various statutory functions by for example: holding details relating to regulated firms, for example their Part IV permissions under the FSMA 2000, and to their senior management; facilitating the collection and collation of regulatory data from those firms, and assisting our staff in the supervision of those firms by generating reports and alerts, and operating the ARROW II methodology for regulating authorised firms. These functions are particular to the FSA, so our 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.

*Key sources of estimation uncertainty*

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

Pension deficit – the quantification of the pension deficit is based upon actuarial assumptions made by the directors (as listed in note 15) relating to rate of increase in salaries, the discount rate, the expected return on the Plan's assets, retail price inflation and future pension increases.

- The assumptions regarding returns on assets are based on market observables for cash (Bank of England's base rate), corporate bonds (15-year AA-rated corporate bond index) and, for equities, the yield on the ten-year benchmark gilt index adjusted by an assumed equity risk premium of 3.0% p.a.
- The discount rate was determined with reference to the market rate of a selection of corporate bonds at the year end, allowing for the anticipated maturity of the Plan's projected benefit cash-flow profile. The change in discount rate assumption from 6.0% to 6.6% has decreased the pension liability by £49.4m.
- The assumption for long-term retail price inflation (r.p.i.) is based on market expectation of long-term future inflation at the year end, as measured by the difference between yields on fixed interest and index-linked Government bonds, reduced by 0.2% p.a. so as to allow for other data sources, such as the Bank of England's long-term inflation target and other long-term consensus indicators. The change in the r.p.i. assumption from 3.4% to 3.0% p.a. decreased the pension liability by £26.5m.
- Generally, the level of annual pension increases awarded by the Plan for pensions in payment is the annual increase in r.p.i., or 5.0% p.a. if lower, although some of the pensions rights transferred in from the FSA's predecessor organisations receive different level of pensions increases.
- The assumptions relating to the mortality of current and future pensioners has remained unchanged since last year. In particular, the projection of improvements to post retirement mortality remains at a "long cohort" projection. The cohort effect describes the phenomenon in the UK whereby population cohorts born between 1925 and 1945 have experienced faster improvements in mortality over their lifetime than adjacent generations. There are "short", "medium" and "long" cohort projections and these represent how long into the future it is expected mortality will continue to improve. The long cohort projection assumes improvements to 2040. This is consistent with the assumption used in our Scheme Specific Valuation at 1 April 2007.
- The effect of any change to these assumptions will be accounted for in the next financial year through the statement of recognised income and expense.

## 4. Business and geographical analysis

*Business units*

For management purposes, the FSA is currently organised into four business units – Retail Markets, Wholesale & Institutional Markets, Operations and Direct Reports.

The principal activities for the four business units are as follows:

*Retail Markets* – focuses on five key aims in order to deliver fair outcomes for consumers: challenging firms to be well governed, financially sound and to effectively manage the risks inherent in their business models and markets; focusing on consumer outcomes and seeking to ensure firms adhere to our conduct principles and treat their customers fairly; driving forward work on consumer capability, enabling consumers to engage proactively and responsibly with financial matters; acting to prevent and deter regulated firms and other market participants from engaging in or facilitating financial crime; and applying a risk and more outcome focussed regulatory approach and regime, intervening pro-actively and proportionately to deliver credible deterrence and redress.

*Wholesale & Institutional Markets* – maintaining efficient, orderly and clean markets. Much of this business unit's work is aimed at establishing and maintaining high standards in the markets which operate in the UK. This embraces questions of disclosure, corporate governance and market behaviour, for which the FSA has varying degrees of responsibility and of influence, as well as other matters, such as supervision, capital adequacy, or the listing regime where the FSA's responsibilities and powers are unambiguous.

*Operations* – improving our business capability and effectiveness. Operations' work is aimed at ensuring we have the right people to deliver our regulatory strategy, equipped with the tools they need to do their job to the best of their ability. This requires focussing on attracting, motivating, developing and retaining talented people as well as effectively running our operational policies and processes in a smooth, economic and efficient way. Operations is responsible for keeping the building and systems running, managing the finances, enhancing the FSA's project delivery capability and looking after the interests of staff.

*Direct Reports* – reporting directly to the Chairman and CEO. Divisions that report directly to the Chairman provide the resources that the Board requires to discharge its stewardship and corporate governance responsibilities. Divisions that report directly to the CEO are responsible for supporting the core supervisory processes (i.e. strategy & risk management, quality assurance, communication and legal advice) and delivering on FSA's credible deterrence strategy.

Segment information about the FSA's continuing operations is presented below:

| **2009**<br>**Year ended 31 March 2009** | **Wholesale & Institutional Markets**<br>**£m** | **Retail Markets**<br>**£m** | **Operations**<br>**£m** | **Direct Reports**<br>**£m** | **Total for continuing operations**<br>**£m** |
|---|---|---|---|---|---|
| **Revenue** | | | | | |
| Fees | | | 324.4 | | 324.4 |
| Sundry income | 6.6 | 5.9 | 7.6 | 1.4 | 21.5 |
| **Result** | | | | | |
| Segmental surplus/ (deficit) | (83.1) | (160.0) | 298.8 | (79.1) | (23.4) |
| Investment income | | | | | 3.2 |
| Other net finance income | | | | | (1.9) |
| Deficit before tax | | | | | (22.1) |
| Income tax expense | | | | | (0.9) |
| Deficit for year | | | | | (23.0) |
| **Other information** | | | | | |
| Capital additions: | | | | | |
| *Property, Plant & Equipment* | | | 26.5 | | 26.5 |
| *Intangible* | | | 14.8 | | 14.8 |
| Depreciation | | | (10.1) | | (10.1) |
| Amortisation | | | (6.3) | | (6.3) |
| Trade receivables impairment losses recognised | | | (0.8) | | (0.8) |
| Current and past pension service costs | (1.7) | (3.8) | (1.6) | (1.5) | (8.6) |

| **2008**<br>**Year ended 31 March 2008** | | | | | |
|---|---|---|---|---|---|
| **Revenue** | | | | | |
| Fees | | | 303.3 | | 303.3 |
| Sundry income | 7.3 | 0.9 | 10.9 | 1.4 | 20.5 |
| **Result** | | | | | |
| Segmental (deficit)/surplus | (77.6) | (124.3) | 259.9 | (66.9) | (8.9) |
| Investment income | | | | | 5.7 |
| Other net finance income | | | | | 1.8 |
| Deficit before tax | | | | | (1.4) |
| Income tax expense | | | | | (1.7) |
| Deficit for year | | | | | (3.1) |
| **Other information** | | | | | |
| Capital additions: | | | | | |
| *Property, Plant & Equipment* | | | 32.2 | | 32.2 |
| *Intangible* | | | 23.8 | | 23.8 |
| Depreciation | | | (8.8) | | (8.8) |
| Amortisation | | | (5.2) | | (5.2) |
| Trade receivables impairment losses recognised | | | (0.6) | | (0.6) |
| Current and past pension service costs | (2.0) | (2.8) | (4.0) | (1.5) | (10.3) |

*Balance Sheet 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, first as fees are not set on the basis of the costs we incur in regulating individual firms, our working capital cannot be allocated to business segments, and second 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. No further geographical analysis is presented.

## 5. Deficit before taxation for the year

Deficit for the year has been arrived at after charging the following, which are included in administrative costs:

| | Note | 2009<br>£m | 2008<br>£m |
|---|---|---|---|
| Depreciation of property, plant and equipment | 10 | 10.1 | 8.8 |
| Loss on the sale of property, plant and equipment | 10 | 0.4 | 0.6 |
| Amortisation of intangible assets | 9 | 6.3 | 5.2 |
| Impairment loss on intangible fixed assets | 9 | – | 2.4 |
| Staff costs | 6 | 205.0 | 185.7 |
| Operating lease rentals | 18 | 13.5 | 12.4 |

In accordance with our accounting policy, we review the carrying value of intangible assets to determine whether there has been any impairment loss, and if so, the extent. No impairment was required in the current period.

Grant Thornton UK LLP (GTUK) were re-appointed as auditors on 24 July 2008.

Auditor's remuneration for audit services as set out below:

| Total fees | 12 months to 31 March 2009 | | 12 months to 31 March 2008 | |
|---|---|---|---|---|
| | £'000 | % | £'000 | % |
| Fees payable to the FSA's auditor for the audit of the FSA's annual accounts | 85 | 91 | 82 | 57 |
| Fees paid to the FSA's auditor or their associates in connection with non-audit work | | | | |
| • Secondments | 3 | 3 | 63 | 43 |
| • Other services | 5 | 6 | – | – |
| **Total** | **93** | **100** | **145** | **100** |

All fees payable to the auditor are stated inclusive of VAT, as VAT is not generally recoverable by the FSA.

Staff seconded by GTUK to the FSA worked as forensic accountants on various investigations conducted by our Enforcement division. They were not involved in the preparation of the FSA's statutory accounts. The Audit Committee has reviewed the nature and content of the non-audit work performed by the auditor to ensure that audit independence was not impaired.

In order not to impair the actual and perceived independence of its auditor, the FSA has a policy of limiting the amount of fees its auditor charges for non-audit services to no more than the fee for performing the audit of its annual accounts. Both the FSA and its auditor are committed to keeping the level of fees for non-audit services in line with its policy on such fees.

## 6. Employee information

The average number of full time equivalent employees (including executive directors) during the 12 months was 2,643 (2008: 2,489). The average number of full time equivalent employees in each function during the current year was as follows:

| | 2009 | Restated[1] 2008 |
|---|---|---|
| Retail Markets Business Unit | 1,030 | 944 |
| Wholesale & Institutional Markets Business Unit | 570 | 534 |
| Operations Business Unit | 503 | 517 |
| Direct Reports | 311 | 294 |
| Enforcement | 229 | 200 |
| | **2,643** | **2,489** |

At 31 March 2009, the FSA had 2,730 (2008: 2,535) full time equivalent employees.

1 The activities within the business units were reorganised during the year. The 2007/08 comparatives have been restated accordingly. We believe that the reorganisation only impacts this financial disclosure.

Employment costs (including executive directors) comprise:

| | Notes | 2009 £m | 2008 £m |
|---|---|---|---|
| Gross salaries and taxable benefits | | 171.0 | 150.3 |
| Employer's National Insurance costs | | 16.0 | 16.1 |
| Employer's pension costs included in administrative costs | | 18.0 | 19.3 |
| | 5 | 205.0 | 185.7 |
| Employer's pension (income)/ costs reported elsewhere | | | |
| Included in other finance costs/(income) | 15 | 1.9 | (1.8) |
| Included in statement of total recognised income and expense | 15 | 1.7 | 13.9 |
| **Total employment costs** | | **208.6** | **197.8** |

## 7. Other revenue

Other revenue comprises:

| | 2009 £m | 2008 £m |
|---|---|---|
| Application fees and other regulatory income | 10.2 | 12.2 |
| Transaction Reporting | 6.1 | 3.0 |
| Publications and training services | 2.2 | 2.8 |
| Benchmarking income | 0.5 | 0.2 |
| Other sundry income | 2.5 | 2.3 |
| | **21.5** | **20.5** |

Application fees are recognised when received, as is the revenue associated with the sale of publications and training services and other sundry income. Fees paid by firms that use our transaction reporting gateways to report their transactions are recognised in a way that matches the income received to the cost of operating our SABRE system. Benchmarking income invoiced relates to a three-year period, and is recognised on a straight-line basis over that time.

## 8. Taxation

The tax charge on ordinary activities is:

| | 2009 £m | 2008 £m |
|---|---|---|
| Current tax on continuing operations | 0.9 | 1.7 |
| Corporation tax charge for the year | **0.9** | **1.7** |

Corporation tax is calculated at 28% (2008: 30%) of the estimated assessable surplus for the year. The total charge for the year can be reconciled to the accounting surplus as follows:

| | 2009 £m | 2008 £m |
|---|---|---|
| Deficit before tax on continuing operations | (22.1) | (1.4) |
| Tax at 28% (2008: 30%) thereon | (6.2) | (0.4) |
| Effects of: | | |
| Adjustment for activities not subject to corporation tax | 7.1 | 2.1 |
| Current tax charge for the period | **0.9** | **1.7** |
| Effective tax rate for the period | **(4%)** | **(121%)** |

Under an agreement with Her Majesty's Revenue and Customs, the company is not subject to corporation tax on income arising from its regulatory activities. Consequently, the tax charge arises solely on interest receivable.

## 9. Intangible assets

| | Software Development costs £m |
|---|---|
| **Cost** | |
| At 1 April 2007 | **31.6** |
| Additions – internally generated | 23.8 |
| Impairment | (2.4) |
| At 1 April 2008 | **53.0** |
| Additions – internally generated | 14.8 |
| **At 31 March 2009** | **67.8** |
| | |
| **Amortisation** | |
| At 1 April 2007 | **16.5** |
| Charge for the year | 5.2 |
| At 1 April 2008 | **21.7** |
| Charge for year | 6.3 |
| **At 31 March 2009** | **28.0** |
| | |
| **Net book value** | |
| **At 31 March 2009** | **39.8** |
| **At 31 March 2008** | **31.3** |

At 31 March 2009, expenditure totalling £16.1m had been capitalised on software developments that had not yet gone into operation (2008: £14.2m).

## 10. Property, plant and equipment

| | Leasehold improvements £m | Computer equipment £m | Furniture and equipment £m | Total £m |
|---|---|---|---|---|
| **Cost** | | | | |
| At 1 April 2007 | **20.8** | **48.1** | **11.5** | **80.4** |
| Additions | 5.9 | 18.9 | 7.4 | 32.2 |
| Disposals | (1.9) | (0.4) | (3.6) | (5.9) |
| At 1 April 2008 | **24.8** | **66.6** | **15.3** | **106.7** |
| Additions | 12.2 | 8.4 | 5.9 | 26.5 |
| Disposals | (3.9) | (1.5) | (3.4) | (8.8) |
| **At 31 March 2009** | **33.1** | **73.5** | **17.8** | **124.4** |
| **Accumulated depreciation and impairment** | | | | |
| At 1 April 2007 | **16.2** | **36.9** | **9.1** | **62.2** |
| Charge for year | 2.7 | 5.0 | 1.1 | 8.8 |
| Disposals | (1.7) | (0.4) | (3.2) | (5.3) |
| At 1 April 2008 | **17.2** | **41.5** | **7.0** | **65.7** |
| Charge for year | 2.5 | 6.5 | 1.1 | 10.1 |
| Disposals | (3.9) | (1.4) | (3.1) | (8.4) |
| **At 31 March 2009** | **15.8** | **46.6** | **5.0** | **67.4** |
| **Carrying amount** | | | | |
| **At 31 March 2009** | **17.3** | **26.9** | **12.8** | **57.0** |
| **At 31 March 2008** | **7.6** | **25.1** | **8.3** | **41.0** |

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. Residual values will be reviewed and updated annually.

## 11. Other financial assets

*Trade and other receivables*

| | 2009 £m | 2008 £m |
|---|---|---|
| Fee receivables | 3.5 | 0.8 |
| Other debtors | 1.0 | 0.8 |
| Prepayments and accrued income | 13.0 | 12.1 |
| **Amounts due within one year** | **17.5** | **13.7** |

The average credit period taken is 37 days (2008: 40 days). A late penalty fee 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 Bank of England Repo rate plus 5%.

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 £0.8m (2008: £0.6m) has been made for the estimated irrecoverable amounts from fees invoiced. This provision has been determined by reference to past default experience.

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 2009. The age of fee receivables past due, but not impaired is as follows:

| | 2009 £m | 2008 £m |
|---|---|---|
| Not more than three months | 0.6 | 1.1 |
| More than three months, but not more than six months | 0.1 | 0.2 |
| More than six months, but not more than one year | 0.2 | 0.2 |
| | **0.9** | **1.5** |

Our policy is to begin 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 receivables more than three months old, but less than six, are relatively low value amounts owed by a large number of debtors.

The balances which are between six months and a year old are a small number of receivables where we are in discussion with the counterparties as to the exact amount due, but do not believe that the balances are impaired. Experience indicates that we would normally expect to collect the proportion of those classes of debtor that are listed above.

*Cash and cash equivalents*

Bank balances and cash comprise cash held by the FSA and short term, fixed rate, bank deposits with an original maturity of one month or less. The carrying amount of these assets approximates their fair value.

*Credit risk*

The FSA's principal financial assets are bank balances and cash, together with fees and other receivables. Liquid funds are placed with counterparties with high credit ratings, as assigned by credit rating agencies.

The FSA's credit risk is primarily attributable to its fee receivables. The amounts presented in the balance sheet are net of allowances for doubtful receivables. An allowance for impairment is made where there is an identified loss event which, based on past experience and management's forecasts, is evidence of a reduction in the recoverability of the cash flows. See above for further information on impairment of financial assets that are past due.

The FSA has no significant concentration of credit risk as its exposure is spread over a number of counterparties.

*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.

*Liquidity risk*

The FSA manages its liquidity by carefully monitoring the projected income and expenditure related to its day-to-day business. Liquidity needs are monitored in various time bands, on a day-to-day, week-to-week and rolling 30-day basis. Each month, we identify long-term liquidity in a 180 and 360 day window, up to the point when we next expect to bill the majority of our fees.

## 12. Trade and other payables

*Current*

| | 2009 £m | 2008 £m |
|---|---|---|
| Trade creditors and accruals | 70.7 | 73.4 |
| Other taxation and social security | 5.6 | 4.9 |
| Financial penalties to be applied against fees receivable | 28.4 | 4.5 |
| Fees in advance | 26.8 | 20.3 |
| | **131.5** | **103.1** |

Trade creditors and accruals principally comprise amounts outstanding for trade purchases and ongoing costs. The average credit period taken for trade payables is 30 days (2008: 28 days). The directors consider the carrying amount of trade payables approximates their fair value.

*Non-current*

A lease accrual of £14.6m (2008: £13.3m), being the cumulative difference between cash paid and expense recognised on operating leases for land and buildings, is recognised as long term liabilities. Details of the above leases can be found in note 18.

As at 31 March 2009, the FSA's liabilities have contractual maturities which are summarised below:

| | **Current** | | | | **Non-current** | | | |
|---|---|---|---|---|---|---|---|---|
| | **Within 6 months** | | **6 to 12 months** | | **1 to 5 years** | | **later than 5 years** | |
| | **2009 £m** | **2008 £m** | **2009 £m** | **2008 £m** | **2009 £m** | **2008 £m** | **2009 £m** | **2008 £m** |
| Trade creditors and accruals | 63.9 | 68.0 | 6.8 | 5.4 | 3.5 | 2.2 | 11.1 | 11.1 |
| Other taxation and social security | 5.6 | 4.9 | - | - | - | - | - | - |
| Financial penalties to be applied against fees receivable | 28.4 | 4.5 | - | - | - | - | - | - |
| Fees in advance | 23.2 | 17.5 | 3.6 | 2.8 | - | - | - | - |
| | **121.1** | **94.9** | **10.4** | **8.2** | **3.5** | **2.2** | **11.1** | **11.1** |

## 13. Borrowings

At 31 March 2009, the FSA had available £98m (2008: £100m) of un-drawn committed borrowing facilities in respect of which all conditions precedent had been met. The facility was taken out on 20 February 2007 and expires 20 February 2010, with any drawings made on the day prior to expiry being repayable in full by 19 May 2010. The £2m of borrowings was repaid in full on 3 April 2009.

The FSA has also obtained a further £100m of un-drawn committed borrowing facilities in respect of which all conditions precedent had been met. The facility was taken out on 28 May 2009 and any future drawings are repayable in full by 27 May 2012.

Both loan facilities are unsecured.

## 14. Long term provisions

| | **Total £m** |
|---|---|
| At 1 April 2008 | 0.3 |
| Utilised in the year | (0.2) |
| Charge in the year | – |
| **At 31 March 2009** | **0.1** |

*Repairs*

This provision relates to the premises we rent at 25 Bank Street, Canary Wharf, London, which will become due when we leave the premises in August 2010 when our lease expires.

## 15. Retirement benefit obligation

The FSA operates a tax-approved pension scheme, the FSA Pension Plan, which is open to permanent employees. The pension scheme was established on 1 April 1998 and operates on both a defined benefit (the Final Salary section) and defined contribution (the Money Purchase section) basis. 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 scheme. Since the Final Salary section of the scheme is closed to new members and the age profile of the active members is increasing, under the projected unit credit method, the current service cost will increase as members of the scheme approach retirement. The Final Salary section of the scheme is non-contributory for members. 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 the pension scheme.

The FSA is at present consulting with current members of the final salary section of the pension plan with a view to ceasing future accrual within that section from April 2010.

*Final Salary section*

The most recent actuarial valuation of the FSA Pension Plan was carried out as at 31 March 2007 by an independent actuary, using the projected unit method, and was signed in March 2008. The results of this valuation have been updated for the purpose of IAS 19 as at March 2009, 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 2009 | At 31 March 2008 |
|---|---|---|
| Expected rate of salary increases | 4.0% | 4.0% |
| Corporate bond discount rate | 6.6% | 6.0% |
| Expected return on scheme assets | 6.3% | 7.1% |
| Retail price inflation (r.p.i.) | 3.0% | 3.4% |
| Future pension increases | 2.9% | 3.4% |

In assessing the value of funded obligations, the mortality assumptions for the Pension Plan are based on current mortality tables and allows for future improvements in life expectancy. The mortality assumptions for 2008 and 2009 are based on an actuarial table 'PA1992, projected to allow for future improvements using long cohort projections and by an individual's year of birth'. The expected rate of salary increases is a long term assumption for pension valuation purposes only, and does not represent a forecast of actual intentions.

The table below illustrates the assumed life expectancies at retirement of staff when they retire (staff are assumed to retire at the age of 60).

| | 2009 years | 2008 years |
|---|---|---|
| **Retiring today** | | |
| Males | 28.6 | 28.5 |
| Females | 31.7 | 31.6 |
| **Retiring in 15 years** | | |
| Males | 29.5 | 29.5 |
| Females | 32.6 | 32.5 |

The results of the valuation are sensitive to changes in the assumptions referred to above. The table below provides an estimate of the sensitivity of the estimates of the present value of pension obligation, and the cost of servicing those obligations, to small movements in those assumptions.

| Assumption | Sensitivity | Increase/(decrease) in pension obligation at 31 March 2009 £m | % | Increase/(decrease) in pension cost in 2009/10 £m | % |
|---|---|---|---|---|---|
| Base line | Assumptions as above – no change | 310.0 | – | 13.5 | – |
| Discount rate | 10 bps increase to 6.7% | (6.6) | (2.1%) | (0.3) | (2.1%) |
| Discount rate | 10 bps decrease to 6.5% | 6.8 | 2.2% | 0.3 | 2.2% |
| Longevity | 1 additional year of life at age 60 | 5.0 | 1.6% | 0.4 | 3.3% |
| Inflation | 0.1% | 5.3 | 1.7% | 0.4 | 3.3% |
| Salary increases | 0.1% | 1.5 | 0.5% | 0.2 | 1.2% |

The amount recognised in the balance sheet is as follows:

| | 2009 £m | 2008 £m |
|---|---|---|
| Fair value of plan assets | 222.8 | 273.3 |
| Less: Present value of funded obligations | (310.0) | (363.0) |
| **Deficit in the scheme** | **(87.2)** | **(89.7)** |
| Unfunded pension liabilities | (1.7) | (1.9) |
| **Net liability recognised in the balance sheet** | **(88.9)** | **(91.6)** |

A small number of current and former employees have benefit promises that cannot be delivered entirely through the tax-approved scheme described above. At 31 March 2009, the liability is £1.7m (2008: £1.9m) to cover the cost of these promises. This year, an amount of £0.1m was included in the total pension cost for the year in note 6, representing the value of the reduction in benefits accrued (2008: £nil).

Amounts recognised in the income statement in respect of the defined benefit plan are as follows:

| | 2009 £m | 2008 £m |
|---|---|---|
| Current service cost | 8.3 | 9.2 |
| Past service cost | 0.3 | 1.1 |
| **Administration expenses** | **8.6** | **10.3** |
| | | |
| Expected return on plan assets | 20.2 | 21.2 |
| Interest on scheme liabilities | (22.1) | (19.4) |
| **Other net finance income** | **1.9** | **1.8** |

Current service costs and past service costs are disclosed as administration expenses; expected return on plan assets and interest costs are disclosed as interest income in the income statement; and actuarial losses of £1.7m (2008: losses of £13.9m) are recognised in the period in which they occur as part of the statement of recognised income and expense.

The actual loss on plan assets was £58.0m (2008: loss of £19.7m).

Changes in the present value of the defined benefit obligation are as follows:

| | 2009 £m | 2008 £m |
|---|---|---|
| Opening obligation | (363.0) | (367.1) |
| Current service cost | (8.3) | (9.2) |
| Past service cost | (0.3) | (1.1) |
| Benefits paid | 7.3 | 6.8 |
| Interest cost | (22.1) | (19.4) |
| Actuarial gains | 76.4 | 27.0 |
| **Closing obligation** | **(310.0)** | **(363.0)** |

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

| | 2009 £m | 2008 £m |
|---|---|---|
| Opening fair value of plan assets | 273.3 | 289.1 |
| Expected return on plan assets | 20.2 | 21.3 |
| Actuarial losses | (78.1) | (40.9) |
| Contributions by the employer | 14.7 | 10.6 |
| Benefits paid | (7.3) | (6.8) |
| **Closing fair value of plan assets** | **222.8** | **273.3** |

The fair value of plan assets and the expected rates of return were:

| | Expected rate of return at 31 March 2009 | Fair value at 31 March 2009 £m | Expected rate of return at 31 March 2008 | Fair value at 31 March 2008 £m |
|---|---|---|---|---|
| Equities | 6.1% | 135.1 | 7.1% | 167.0 |
| Corporate Bonds | 6.7% | 62.6 | 6.9% | 69.1 |
| Property | 6.1% | 16.9 | 7.4% | 24.8 |
| Currency Management | 6.1% | 6.3 | 7.4% | 9.4 |
| Cash | 0.5% | 1.9 | 5.3% | 3.0 |
| **Closing fair value of plan assets** | **6.3%** | **222.8** | **7.1%** | **273.3** |

Cumulative actuarial gains and losses recognised in equity:

| | 2009 £m | 2008 £m |
|---|---|---|
| 1 April | (52.0) | (38.1) |
| Net actuarial losses recognised in the year | (1.7) | (13.9) |
| **At 31 March** | **(53.7)** | **(52.0)** |

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 scheme liabilities are as follows:

| | 2009 | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|
| Defined benefit obligation (£m) | (310.0) | (363.0) | (367.1) | (340.1) | (261.1) |
| Fair value of plan assets (£m) | 222.8 | 273.3 | 289.1 | 250.6 | 182.2 |
| **Net deficit (£m)** | **(87.2)** | **(89.7)** | **(78.0)** | **(89.5)** | **(78.9)** |
| Experience adjustments on scheme assets: | | | | | |
| Amount (£m) | (78.1) | (40.9) | (8.7) | 38.8 | 2.4 |
| Percentage of scheme assets | 35.1% | 15.0% | 3.0% | 15.5% | 1.3% |
| Experience gains and losses on scheme liabilities: | | | | | |
| Amount (£m) | 0.6 | (0.3) | (0.7) | 0.1 | (0.3) |
| Percentage of the present value of scheme liabilities | 0% | 0% | 0% | 0% | 0% |

The contribution rate for 2008/09 was 29.5% of pensionable earnings plus £5.8m (19.9% of pensionable earnings) as an additional deficit reduction contribution. The Scheme Specific Valuation (SSV) as at 31 March 2007 showed a deficit of £29m. The agreed contribution rate for 2009/10 is 29.5% of pensionable earnings. In addition, we committed to clear the SSV deficit over ten years by making additional pension deficit reduction contributions of £11.8m a year, beginning in 2010/11. We made pension deficit reduction contributions totalling £5.8m in 2008/09 and have committed to raise this to £9.8m in 2009/10.

*Defined contribution scheme*

The total expense recognised in the income statement of £10.7m (2008: £9.0m) represents contributions payable to the plan by the FSA at rates specified in the rules of the Plan.

## 16. Accumulated deficit

| | £m |
|---|---|
| At 1 April 2007 | (81.4) |
| Deficit for the year | (3.1) |
| Actuarial gains and losses for the year in respect of the defined benefit pension scheme | (13.9) |
| At 1 April 2008 | (98.4) |
| Deficit for the year | (23.0) |
| Actuarial gains and losses for the year in respect of the defined benefit pension scheme | (1.7) |
| **At 31 March 2009** | **(123.1)** |

The FSA is a company limited by guarantee. 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.

## 17. Capital commitments

The FSA had entered into contracts at 31 March 2009 for capital expenditure totalling £7.4m (2008: £10.9m), which is not provided for in the accounts.

## 18. Operating lease arrangements

| | 2009 £m | 2008 £m |
|---|---|---|
| Minimum lease payments under operating leases recognised as an expense in the year | 13.5 | 12.4 |

At the balance sheet date, the FSA has outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows:

| | 2009 £m | 2008 £m |
|---|---|---|
| Within one year | 13.7 | 11.6 |
| In the second to fifth years inclusive | 52.4 | 48.1 |
| After five years | 58.4 | 71.0 |
| | **124.5** | **130.7** |

Operating lease payments represent rentals payable by the FSA for some of its office properties.

The lease on 25 The North Colonnade, Canary Wharf, London, will expire in 2018. Under the terms of the lease, the rent for the period from 4 November 2003 to 3 November 2004 was agreed at £9.5m. Thereafter, the rent payable until 3 November 2008 increased by 2.5% each year. From 4 November 2008 until 3 November 2018 rent will increase in line with r.p.i subject to a minimum annual increase of 2.5% p.a. and a maximum of 5% p.a. As mentioned in note 15, our current assumption for r.p.i. is 3.0% p.a.

The lease on 18th Floor, Canary Wharf Tower, London, was taken out in January 2008 and contains provision for a rent review in March 2013. The lease will expire in November 2018.

The lease on 16th Floor, 25 Bank Street, Canary Wharf, London, was taken out in March 2005 and contains no provisions for rent reviews. The lease will expire in September 2010.

The lease on Quayside, Edinburgh was taken out in September 2005, contains provision for a rent review in September 2010 and September 2015 and is due to expire in August 2020.

## 19. Related party transactions

*Remuneration of key management personnel*

The remuneration of directors, who are the key management personnel of the Authority, is set out below in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. Further information on individual directors is provided in the audited part of the Corporate Governance Statement on pages 73 to 82.

| | **2009 £m** | **2008 £m** |
|---|---|---|
| Short-term benefits | 3.2 | 3.2 |
| Post-employment benefits | 0.1 | 0.1 |
| | **3.3** | **3.3** |

There were no other transactions with directors 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 significant transactions were:

a) The Financial Services Compensation Scheme Limited (FSCS)

The FSA appoints, and has the right to remove, directors to the board of FSCS and it establishes the rules under which the Scheme operates. Under statute (FSMA) and the Memorandum of Association of FSCS, the FSA has to ensure that the terms of appointment of the directors procure their operational independence from the FSA. Accordingly, the FSA does not control FSCS, but does consider it to be a related party.

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 net amount of fees collected that remained to be paid over by the FSA to FSCS at 31 March 2009 was £0.1m (2008: £0.1m). The charge for the service was £0.3m (2008: £0.2m).

The FSA is a party to the lease agreement for FSCS's premises, occupied from 18 June 2001 on the 7th floor at Lloyds Chambers, Portsoken Street, London, as guarantor of performance of the lease. This lease is for a term from 13 February 2001 to 21 June 2018 at a current annual rental and related out-goings of £0.9m. This guarantee was provided when the FSCS was in its start-up phase, ahead of its formal fee-raising powers being granted under the Financial Services and Markets Act 2000. The FSCS did not provide any consideration in return for that guarantee. As there is not an active market for such guarantees of this nature, no valuation technique could be used to calculate a fair value. Consequently, given the lack of consideration, and the strength of the financial covenant of both the FSCS funding arrangements, no fair value was assigned on inception.

b) The Financial Ombudsman Service Limited (FOS)

The FSA established FOS, a company limited by guarantee, in accordance with the FSMA to exercise the functions of the operator of the ombudsman scheme. Under the FSMA and the Memorandum of Association of FOS, the FSA has to ensure that the terms of appointment of the directors procure their operational independence from the FSA. Accordingly, the FSA does not control FOS, but does consider it to be a related party.

The FSA is the principal employer in the FSA Pension Scheme described in note 15. FOS is also a participating employer in the same scheme making contributions at the same overall rate as the FSA. The assets and liabilities disclosed in note 15 represent only those that relate to the employees of the FSA. The total number of scheme members is 2,223 (2008: 2,160) of which 2,083 are, or were, employees of the FSA (2008: 2,021) and 140 of the FOS (2008: 139).

In 2005/06 the FSA entered into an agency agreement with FOS 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 is £0.1m (2008: £0.1m). As at 31 March 2009, £0.1m of fees relating to 2008/09 invoices had been collected but not paid to FOS, together with a further £1.8m in respect of on-account fees for 2009/10 (2008: £2.7m).

The FSA is a party to the lease agreement for part of the FOS premises at South Plaza II, London, as guarantor of performance of the lease, which is for a 15-year term from 2 November 1999, at a current annual rental of £1.1m. The guarantee was provided when the FOS was in its start-up phases, ahead of its formal fee-raising powers being granted under the FSMA. The FOS did not provide any consideration in return for the guarantee. Given the lack of consideration, and the strength of the financial covenant of the FOS funding arrangements, no fair value was assigned on inception. The current market value of the guarantee has been calculated and determined to be immaterial.

*The Office of the Complaints Commissioner*

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 Office of the Complaints Commissioner (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 2008/09, the FSA has transferred £0.5m (2008: £0.5m) to the OCC to cover the latter's running costs, which have been expensed in the FSA's income statement. At 31 March 2009, the balance owing to the FSA from the OCC was £nil (2008: £0.1m).

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. 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 accounts, including 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.

Other than disclosed above, there were no related party transactions during the year (2008: £ nil).

## 20. Contingent Liabilities

As described in note 19 the FSA acts as guarantor for leases entered into by the FSCS and the FOS. Given the strength of those organisations' fee-raising arrangements, no liabilities are expected to crystallise in respect of those guarantees.

In discharging its responsibilities under the FSMA and its predecessor legislation, the FSA faces the possibility of certain parties making claims as a result of that work. On the basis of the information presently available to it, the FSA believes that any claims would have no real prospect of success. Accordingly, no provision has been made in the accounts for these matters.

## 21. Notes to the cash flow statement

| | Notes | 2009 £m | 2008 £m |
|---|---|---|---|
| Deficit for the year from continuing operations | | (23.0) | (3.1) |
| Adjustments for: | | | |
| Interest received on bank deposits | | (3.2) | (5.7) |
| Corporation tax expense | 8 | 0.9 | 1.7 |
| Amortisation of other intangible assets | 9 | 6.3 | 5.2 |
| Impairment loss on intangible fixed assets | 9 | - | 2.4 |
| Depreciation of property, plant and equipment | 10 | 10.1 | 8.8 |
| Loss on sale of property, plant and equipment | 10 | 0.4 | 0.6 |
| Decrease in provisions | 14 | (0.2) | (1.8) |
| Difference between pension costs and normal contributions | 15 | 1.6 | 1.3 |
| Additional cash contributions to reduce pension scheme deficit | 15 | (5.8) | (3.4) |
| Payments made on unfunded pension liability | 15 | (0.2) | - |
| Operating cash flows before movements in working capital | | (13.1) | 6.0 |
| Increase in receivables | | (3.8) | (3.1) |
| Increase in payables | | 29.7 | 24.1 |
| **Net cash generated from operations** | | **12.8** | **27.0** |

Cash and cash equivalents comprise cash at bank and other short-term highly liquid investments with a maturity of three months or less.

# Statement of allocation of costs for the year ended 31 March 2009

## Introduction

The FSA sets fees by reference to blocks of fee-payers conducting similar activities, which as far as possible, reflect the FSA's costs applicable to the respective fee-blocks. The statement of allocation of costs on page 117 shows the allocation of costs for the year ended 31 March 2009, analysed by those fee-blocks.

Costs are allocated according to the method set out in note 1 on page 115. The report of the auditors is set out on page 118.

# Notes to the statement of allocation of costs for the year ended 31 March 2009

## 1 Method of allocation

The Financial Services and Markets Act 2000 provides that the FSA may make rules providing for the payment of fees to meet its expenses in carrying out its function, or for any incidental purposes and to maintain adequate reserves.

Under the current fee-raising arrangements, the FSA's fees are set by reference to costs applicable to categories of firms or bodies or individual bodies (fee-payers). These categories are known as fee-blocks. The allocation of costs to fee-blocks is primarily made by reference to costs applicable to each fee-payer. Where costs cannot be directly attributed to individual fee-payers they have been allocated to fee-blocks on a basis considered appropriate by the Directors, such as on the headcount of departments, or the estimated time or resources spent on the supply of services for each fee-payer within departments.

## 2 Allocation of net liabilities, excluding pensions liabilities

We apply IAS 19 in accounting for the costs of our defined benefit pension scheme. Given the long term nature of our final salary pension liabilities, and the fact that we cannot predict with certainty how our resources will be allocated over this time scale, we do not allocate those pensions liabilities to fee-blocks.

## 3 Reconciliation from the income statement to net costs for the year as shown on the cost allocation statement

| | **Year ended 31 March 2009 £m** |
|---|---|
| Net costs (includng taxation) for the year | 347.4 |
| **Add**: difference between accounting charges for provisions in the statutory accounts and the related cash costs of pension contributions paid | 6.0 |
| **Less**: costs of implementing more outcomes-focussed regulation | (15.9) |
| **Less**: Reserve movements (ie change in scope and deferred IS costs) | (0.7) |
| **Less:** SEP and Lifecycle costs | (15.4) |
| **Net costs for the year on statement of allocation of costs** | **321.4** |

While adopting IAS 19 provides greater transparency of the impact of pension costs on our financial position, it introduces significant volatility into both the figures reported in our income statement and in our balance sheet. In order to prevent IAS 19 transmitting this volatility into our fee calculations, we exclude any non-cash elements of pension costs from our Annual Funding Requirement (AFR). Our AFR is calculated to include only the cash value of the pension contributions we need to make in a year to cover the increase in the scheme's final salary liabilities due to additional years' service and to salary increases. Also, the AFR includes any deficit reduction contributions aimed at reducing the size of the scheme's deficit to ensure that it can meet its obligations. This is consistent with the fact that, as mentioned above, we have not allocated the pensions liabilities to fee-blocks.

Full details of the calculation of the AFR for 2009/10 are included in *Consolidated Policy Statement on our fee-raising arrangements and regulatory fees and levies 2009/10, including feedback on CP08/18, CP09/7 and 'made rules'* (CP09/8), published in June 2009.

# Statement of allocation of costs for the year ended 31 March 2009

| Fee-block | | Net assets, excluding pensions obligation, at 1 April 2008 £m | Net costs for the year £m | Fees for the year £m | Net assets/(liabilities), excluding pensions obligation at 31 March 2009 £m |
|---|---|---|---|---|---|
| A.1 | Deposit acceptors | 4.9 | (67.0) | 60.0 | (2.1) |
| A.2 | Mortgage lenders and administrators | (0.9) | (6.1) | 6.2 | (0.8) |
| A.3 | General insurers | (1.2) | (18.3) | 17.0 | (2.5) |
| A.4 | Life insurers | 4.7 | (45.9) | 44.1 | 2.9 |
| A.5 | Lloyd's Managing Agents | (0.8) | (1.2) | 0.9 | (1.1) |
| A.6 | The society of Lloyd's | - | (1.2) | 1.3 | 0.1 |
| A.7 | Fund managers | 2.6 | (29.8) | 31.6 | 4.4 |
| A.9 | CIS operators, trustees and depositories | 1.6 | (6.6) | 5.8 | 0.8 |
| A.10 | Firms dealing as principal | (3.0) | (15.7) | 16.5 | (2.2) |
| A.12 | Advisory arrangers holding client money and/or assets | (1.8) | (20.1) | 20.6 | (1.3) |
| A.13 | Advisory arrangers not holding client money and/or assets | (2.5) | (40.5) | 42.6 | (0.4) |
| A.14 | Corporate Finance Advisors | 0.6 | (6.8) | 6.9 | 0.7 |
| A.18 | Mortgage lenders, advisers, and arrangers | (3.8) | (11.9) | 11.1 | (4.6) |
| A.19 | General insurance mediation | 1.8 | (32.8) | 33.8 | 2.8 |
| A. 20 | European Alternative Instrument Identifier (AII) | - | (1.7) | 0.5 | (1.2) |
| B | RBs | 0.4 | (4.6) | 4.5 | 0.3 |
| C | CIS | (0.3) | (0.8) | 1.7 | 0.6 |
| D | DPBs | 0.4 | (0.1) | 0.2 | 0.5 |
| E | UKLA | 3.0 | (8.7) | 9.9 | 4.2 |
| F | Registrant only | (0.8) | (1.6) | 1.6 | (0.8) |
| G | Firms registered under Money Laundering Regulations | (0.4) | - | 0.1 | (0.3) |
| | Total | 4.5 | (321.4) | 316.9 | - |
| | More Outcomes-Focused Regulation | 5.0 | (15.9) | 5.0 | (5.9) |
| | Amortisation of £20m pension contribution | (12.7) | - | 2.5 | (10.2) |
| | Change in Scope and deferred IS costs | (3.6) | 0.9 | - | (2.7) |
| | SEP and Lifecycle costs | - | (15.4) | - | (15.4) |
| | **Net deficit excluding pensions obligation** | **(6.8)** | **(351.8)** | **324.4** | **(34.2)** |

The fee-block descriptions above have been summarised for the purposes of this statement. A full description of the fee-block can be found in the relevant section of the FSA's Handbook.

# Report by independent auditors to the directors of the Financial Services Authority on the statement of allocation of costs

We have examined the statement of allocation of costs to regulated fee-payers ("the Statement") for the year ended 31 March 2009 and the related notes 1 to 3, as prepared by the directors of the company. The Statement has been prepared on the basis set out in note 1.

This report is made solely to the directors of the company. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the directors of the company, as a body, for our review, for the statement, or for the opinions we have formed.

## Respective responsibilities of directors and Grant Thornton UK LLP

The company's directors are responsible for the assumptions and basis on which the costs are allocated to fee-payers and the preparation of the Statement in accordance with note 1. We have performed certain procedures on the Statement, in accordance with our engagement letter dated 3 April 2009, to verify that the assumptions made by the directors have been applied to the allocated amounts.

## Basis of opinion

The procedures we performed did not constitute a review or an audit of any kind and consisted primarily of verifying whether the figures in the Statement have been compiled from amounts extracted from the company's accounting records, and in accordance with the basis set out in note 1.

The procedures we performed were not designed to and are not likely to reveal fraud and there is no assurance that our procedures will reveal all matters of significance related to the Statement.

## Opinion

In our opinion, the Statement has been compiled from amounts extracted from the accounting records and has been prepared in accordance with the basis set out in note 1.

Grant Thornton UK LLP
Chartered Accountants
London

28 May 2009

# Appendices

The following appendices will appear on our website only:

www.fsa.gov.uk/Pages/Library/Corporate/Annual/Index.shtml

| | |
|---|---|
| One | Costs of regulatory authorities in other jurisdictions |
| Two | Accountability<br>The FSA's response to: The Practitioner Panel<br>The Smaller Business Practitioner Panel<br>The Consumer Panel |
| Three | Complaints against the FSA 2008/09 |
| Four | The FSA's response to the Complaints Commissioner's Annual Report for 2008/09 |
| Five | Enforcement activity 2008/09 |
| Six | Performance against 2008/09 milestones |
| Seven | Financial Capability: progress against 2008/09 targets |
| Eight | Statistics |

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