FSA®

Financial Services Authority

Business Plan 2007/08

Promoting efficient, orderly and fair markets

Helping retail consumers achieve a fair deal

Improving our business capability and effectiveness

This Business Plan covers the financial year 1 April 2007 – 31 March 2008. References to quarters in the body of the text are to the calendar year – for example, 'Q3 2007' is the period July – September 2007.

Financial Services Authority
Business Plan
2007/08

© Financial Services Authority 2007
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk
All rights reserved

Contents

Foreword by the Chairman

Callum McCarthy, FSA Chairman

The year ahead – like all years – will be a busy one for the FSA. Our present task is to prioritise among the many possible demands on us, and to devote resources to those risks which are most important, and where the FSA can be most effective. This document sets out how we plan to do this. It outlines: the major pieces of work under the three headings which give coherence to all our work; the timetable against which we plan to do that work; and the resources which we believe we need. We will report on – and you will no doubt judge – how we have measured up against these plans when we report on the 2007/08 year in June 2008.

The FSA's priorities do not change markedly from one year to the next. This reflects the overall continuity in our policy principles: a determination to seek market solutions where possible, and intervene by regulation only where the market does not provide a solution and when the benefits of intervention outweigh the costs; and an explicit recognition that it is neither possible nor desirable to seek to prevent all failures. It also reflects the continuity of approach and direction given by the Board, the body responsible for the FSA's overall direction. These principles are set by the FSA Board. So, although 2007/08 will see the departure of John Tiner, the principles which underpin our Business Plan, and our determination to implement it effectively, will not change with changes to the FSA's management team. Choosing a successor to John Tiner, whose decision to stand down I both understand and greatly regret, will be a major Board responsibility.

Of course, were the economic and financial conditions for us and the financial services industry to change markedly, we would reassess our priorities. But we do not judge that that has happened. Our assessment for the year ahead, set out in our Financial Risk Outlook published on 31 January, is that the most probable outcome against which we and others should plan is a further year of benign economic development. As always, there are a number of developments which could upset this, and any correction might be all the more severe for coming after an extended period of low volatilities. I am also conscious that, although we have benefited from a long period of economic growth and stability, in other respects the world has become more dangerous. Geo-political risks, with their wide implications for users and producers of financial services, are growing.

For all the continuity which characterises our work, there has been over time some significant rebalancing in how we deploy our resources. First, we have decided, as a deliberate and long-term change of emphasis, to devote more resources to discharging our financial capability responsibilities. Whereas in 2004/05 we spent £3.6 million on this, next year we plan to spend £17.1 million – a level of spend which we expect to need to sustain for several years. So many of the problems in the retail market for financial services are rooted in the low level of financial capability of those increasingly required to take financial decisions that we believe this large and sustained increase is both justified and necessary. The overall responsibility for literate and numerate adult citizens lies with government; we welcome the Government's recent launch of its long-term approach to financial capability and its endorsement of our leadership of the national strategy. Our increased spend in this area is designed to achieve focused and specific improvements. We know from the baseline survey which we published in 2006 how great is the need.

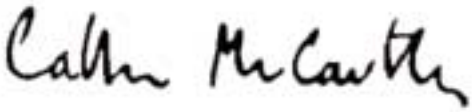
A second major change we plan is to upgrade the FSA's information systems and technology, where we believe we have substantial work to do to catch up. We expect the firms we supervise to maintain their information systems to a standard appropriate for their business, and we plan to apply the same standards to ourselves. The Board is clear that we need to spend significant amounts on IT if the FSA is to make the improvements in productivity which are such a central part of our plans. Without it, we will not be able to make the changes in behaviour we believe necessary for the FSA to maintain its performance and reputation.

We are also taking this opportunity to invest for the future in other areas too, in particular to ensure that we attract and retain the staff we need to implement the more principles-based approach to regulation which we are convinced will deliver the best results for UK firms, markets and consumers.

In his Overview John Tiner explains the impact of these decisions on our budget for 2007/08, which has the full support of the Board.

The other important change which has occurred over time has been extensive additions to the FSA's responsibilities, notably regulation of an additional 14,000 firms in the mortgage and general insurance sectors, which we took on during 2004/05. This has had a substantial effect both on our budget (in 2007/08 we plan to spend £47.3 million on this sector, compared with the £15 million budgeted to set up the regime in 2003/04), and on our internal processes; we have had to design and operate efficient ways of doing business with a very large number of firms, the great majority of whom were small and without previous experience of statutory (or any) regulation. While I believe that they – and we – have coped well with this experience, I am concerned that any further substantial widening of the FSA's duties runs the risk of blurring the existing focus which we have worked hard to achieve, and which I am clear brings substantial benefits to all affected by the FSA's work. I hope that any addition to our responsibilities will take account of this in the decision on how best any public policy objective is pursued administratively and organisationally.

As always, we welcome your views on our plans.



Callum McCarthy
February 2007

Chief Executive Officer's Overview

John Tiner, FSA Chief Executive

Our drive towards more principles-based regulation is our main strategic priority for the coming year. This requires significant changes in three main areas: first, what I call 'the regulatory architecture' (our Handbook and the ways in which we explain our requirements to firms and markets); second, the skills and behaviour of our people; and, third, our information systems.

In the coming year we will also place increasing emphasis on financial capability, which should lead to more confident, capable consumers to take advantage of solutions offered by a dynamic market place.

This Business Plan sets out our full programme of work for the coming year and the extra resources, agreed by the Board, which are needed to fund it. Our budget will rise by around £27.6m, a 10.1% increase on 2006/07. The main elements of this increase are:

- An increase of £7.4m in our spending on financial capability, taking our total expenditure in 2007/08 to £17.1m. This level of spending, which has been allocated to specific and measurable activities, is necessary in order to meet the targets already announced for our National Strategy for Financial Capability.
- Additional investment in our IT infrastructure and delivery. We have decided to outsource a significant part of our IT operations. This multi-year contract is overall highly cost-efficient but involves high up-front costs, resulting in a budget for 2007/08 £11.3m higher than our forecast actual expenditure in 2006/07.

In addition, the Board has approved a budget of up to £50m over the next three years to improve the effectiveness of our people and to support the move to a more principles-based approach. This will cover non-recurring transition expenses such as staff re-organisation costs, training and development and improving our Knowledge Management systems and practices. We anticipate funding more flexible and competitive levels of pay for our best people through reduced overall numbers of staff. The benefits of this expenditure will accrue to firms in the future and we have therefore decided to amortise the actual costs over a period of ten years.

I realise that this level of increase will concern many of our fee payers. However, the Board is convinced that this is necessary to increase our effectiveness and deliver our statutory objectives. The plan includes substantial and continuing improvements in efficiency and productivity. The Annual Funding Requirement – the amount of money we will need to raise from firms in fees in 2007/08 – is £300.1m, an increase of 9.5% on 2006/07.

More principles-based regulation

I believe that a more principles-based regulatory approach will produce significant benefits for firms, markets and consumers:

- Firms will have increased flexibility to decide which business and operating processes are appropriate to their activities and types of customer. This should eliminate redundant processes, reduce duplication and ultimately lead to lower costs.
- Customers will benefit from firms more attuned to their needs and will receive information from firms which is more fit-for-purpose.

- The FSA will be better placed to have businesslike conversations with firms, make risk-based judgements and provide clear, timely and relevant responses to firms' questions.

At the beginning of this year, I held a series of meetings with chief executives of regulated firms to discuss the practical implications of our emerging regulatory approach. This has helped inform our vision of a more principles-based regulatory regime, which we will set out in more detail in a paper in April. This will also outline how we intend to work with firms and others to tackle the challenge of implementation. We will continue to discuss our thinking with our stakeholders in the UK and international colleagues.

I am conscious of the particular issues faced by smaller firms in understanding and complying with our requirements. They want clear, timely and relevant information from us, but do not want to be deluged with bulletins and other communications which they do not have the capacity to absorb. We will continue to work at striking the right balance here, recognising the management's own responsibilities for taking the decisions that affect their firm and customers.

Our people strategy

We place increasing emphasis on recruiting people with direct experience of the financial services industry who have relationship management skills and technical expertise in particular areas. We are carrying out further work to identify the skills needed by staff in each of the major disciplines in the FSA (supervision, policy, enforcement etc) and are generally raising the expectations we have of our people.

We have said that as part of this change we envisage headcount reducing by about 300 by the end of the decade. We expect to make significant progress towards this during the coming year.

We also plan to invest further in our people by stretching the pay ranges in our job family structure, increasing the bonus that can be earned by exceptional performers, continued use of deferred retention bonuses, better accommodation of flexible working practices and doubling our expenditure on training and development. I believe these initiatives will help us to retain the people we need and attract new talent to the FSA.

Regulatory priorities

Our three strategic aims remain: promoting efficient, orderly and fair markets; helping retail consumers achieve a fair deal; and improving our business capability and effectiveness. Work to deliver results under these headings represents the bulk of our day-to-day activities. Most of what we plan in the coming year is either required to implement EU legislation or other international commitments or is a continuation of programmes of work already started. We will remain focused on themes such as Treating Customers Fairly, retail distribution, payment protection insurance and commission transparency in the insurance sector. We are also committed to stepping up our efforts to prevent, detect and prosecute market abuse and other forms of financial crime.

Sections 1-3 of this Plan provide further detail of work in these areas, but I want to deal with enforcement and international issues separately below.

Enforcement

Enforcement continues to be an important tool in supporting our supervisory, thematic and market-monitoring activities. We see enforcement as a strategic tool in securing behavioural change in firms in those areas where we believe the risks to our statutory objectives are highest. We will pursue the cases we consider will have the most impact, particularly where the protection of consumers or the cleanliness of markets is an issue.

Our overall regulatory priorities drive our enforcement activities; they do not have distinct or free-standing priorities. So, for example, our new division which focuses on reducing the use of the financial system for criminal purposes will be supported by enforcement in delivering its objective. In the past, we have achieved successful enforcement outcomes in the wholesale markets for breaches of our high-level principles without reference to detailed rules. As we move towards a more principles-based approach across the FSA, I expect this trend to continue and for more actions to be taken in the retail market for breaches of principles only.

We have now fully embedded the recommendations of the 2005 Enforcement Process Review in our processes and I am satisfied that these are facilitating efficient, effective and fair outcomes. I expect that the trend towards executive settlements will continue in 2007/08 and that fewer, but more contentious and complex, cases will be taken through the whole process to the Regulatory Decisions Committee and, possibly on to the Tribunal. We will be resolute in tackling difficult cases, including

those where we recognise from the beginning that it might be difficult to secure a disciplinary outcome, but where we believe it is appropriate to pursue the case. We will also continue to use the range of disciplinary sanctions available, including the prosecution of matters such as criminal offences where appropriate.

International

We will continue to dedicate significant effort, including at the most senior level, to influencing the international agenda and to shaping individual policy initiatives. Our International Strategy and Policy team will continue to coordinate our international work to ensure our strategy is focused, coherent and successful.

Of course much of our work is directed to developments in the EU. Implementing the Capital Requirements and Markets in Financial Instruments Directives will require significant effort from us and the market in the coming year.

We will continue to play an active role in shaping Solvency 2, including how it should apply to insurance groups in the EU. We await the outcome of the Interim Institutional Monitoring Group on the effectiveness of the Lamfalussy processes and will participate actively in the consideration of its findings, conclusions and recommendations concerning the future structure of regulation in the EU. Meanwhile we will continue to play a leading role in CESR, CEBS and CEIOPS – where there is much work to be done in advising the Commission, improving the coherence of regulatory standards and approaches among Member States, and clarifying the roles and responsibilities of regulatory bodies in respect of cross-border business. We will also continue to emphasise the importance of better regulation, in terms of market failure and cost-benefit analyses, seeking market alternatives to statutory regulation and the merits of principles and risk-based approaches.

At the broader international level, we will continue to play a leading part in the Basel Committee, IOSCO and the IAIS. We will also build on the relationships we have established with regulators in other major economies in order to share best practices, discuss matters of common interest and resolve international regulatory issues. In particular we will invest further in our relationships with the US regulatory authorities, including tests on handling financial crises which might affect both UK and US financial institutions and markets.

I am conscious that I will not be here to lead the FSA beyond July. I am confident, however, that the priorities which are set out in this plan, particularly our drive to more principles-based regulation, have the full support of the FSA's senior management team and will be implemented enthusiastically in 2007/08 and beyond. We are all committed to doing so.

John Tiner
February 2007

1 Promoting efficient, orderly and fair markets

Introduction

Our work to promote efficient, orderly and fair markets affects both wholesale and retail firms. Where we have discretion, we work with the industry to address market failures – preferring market-based solutions to regulatory intervention wherever possible. Where our work is non-discretionary, for example when it is driven by EU directives, we devote significant resource to assisting the Treasury and the Lamfalussy Committees – the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) – in negotiations. We will continue to take this approach in 2007/08. We will also continue to consider what further improvements or changes we can make to the regulatory regime to optimise London's attraction as an efficient, orderly and fair market.

For firms, the most significant European measures which they will continue to need to prepare for are the Markets in Financial Instruments Directive and the Capital Requirements Directive. We will devote significant supervisory resource to helping firms with implementation. Our other key focus will be on negotiating the Solvency 2 Directive, where we are seeking to influence EU-wide risk-based solvency requirements for insurers.

We will continue to take a risk-based, and increasingly will take a more principles-based, approach to supervising firms across the retail and wholesale markets. In addition to the work we do with individual firms, we will also carry out a number of thematic reviews in the banking, insurance, asset management and capital markets sectors. This will include work on unconfirmed trades, commission disclosure, valuation of illiquid instruments and leveraged lending.

Reducing the risks posed by market abuse and financial crime will also be key priorities for 2007/08. To support our work on market abuse we will continue our development of our new transaction monitoring system, Sabre 2, which will be implemented over this year and next. To address the rising risk of financial crime we have launched a three-year strategy, which focuses on encouraging firms to adopt risk-based measures and targeting firms that fail to do so.

EU policymaking

As outlined in our International Regulatory Outlook published in November 2006, one of the priority risks to achieving our aim of efficient, orderly and fair markets is the **substantial volume of international regulatory change** affecting UK financial institutions. Most of the directives arising from the European Commission's (the Commission's) Financial Services Action Plan are now at implementation stage but we expect policymaking in the UK to continue to be heavily influenced by EU and international developments. So it is important that regulation emerging from the EU is proportionate and consistent with our risk-based and more principles-based approach. We continue to promote better regulation disciplines in Europe and we welcome the Commission's commitment to consultation and the publication of impact assessments for all new proposed measures.

We remain strongly supportive of the **Lamfalussy process** and believe this is the most effective means of achieving regulatory convergence and improving the effectiveness and efficiency of supervision (*see CEO's Overview*).

Implementation of the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD)

Markets in Financial Instruments Directive

MiFID introduces new and more extensive requirements for a wide range of firms, particularly in relation to conduct of business and internal organisation. In January 2007 we finalised the rules that are essential for implementing the MiFID requirements.

Through a combination of firm-specific and thematic work we will monitor and evaluate firms' preparations ahead of implementation on 1 November 2007. We will encourage industry initiatives to support compliance with the new rules, such as the use of industry guidance. In addition, in Q1 2008 we will begin a risk-based review of whether firms affected by MiFID have implemented the requirements appropriately.

We plan to publish in 2007:

- a Consultation Paper in Q2 on our proposals for a review of the conduct of business requirements for certain categories of business outside the scope of MiFID;
- a Consultation Paper in Q3 on the possible extension of the common platform of requirements on systems and controls to non-MiFID and non-CRD scope firms;
- consultations on consequential rule changes arising because of MiFID;
- a Permissions and Notifications Guide for firms in March; and
- a Transaction Reporting Users Pack in Q3, providing technical assistance to those dealing with transaction-reporting issues.

During the year we will also continue to participate in the work being led by CESR on practical regulatory issues arising from MiFID. In addition, we will work with industry and in CESR to secure appropriate, evidence-based policy outcomes in the Commission's report on the appropriateness and effectiveness of a number of the Directive's provisions.

We have used the implementation of MiFID as an opportunity to review and simplify our Conduct of Business Sourcebook. These changes will affect all firms subject to our current conduct of business rules, many of which will not fall within the scope of MiFID (*see Section Two*).

Capital Requirements Directive

The aim of the CRD is that the financial resources held by banks, building societies and investment firms reflect the risks associated with their business profile and control environment. 2007 is a transitional year – firms may elect to remain on the Basel 1-based rules for some or all of 2007. All firms subject to the CRD must have adopted the new regime by 1 January 2008.

During 2007 we will continue to review applications from firms wanting to adopt the internal ratings based approach (IRB) to credit risk and the advanced measurement approach (AMA) to operational risk. This will involve significant supervisory and specialist resource. We expect the new risk modelling techniques introduced under the CRD to lead to improvements in firms' risk management. These improvements should also help firms to manage the risks identified in our Financial Risk Outlook (FRO), published in January. In addition, we will review firms' Individual Capital Adequacy Assessment Process (ICAAP) submissions under Pillar 2 and give individual capital guidance. Finally, we will continue to review applications for CAD 2 model approvals for market and counterparty risk.

We will take the following steps to help firms in their transition to the new regime:

- publish benchmarking data on Pillar 2 capital levels;
- give feedback to the industry on lessons learned as the project progresses; and
- liaise with overseas regulators and international bodies to promote consistent and efficient application of Basel 2/CRD requirements (*see International work*).

We also plan to consult further in Q4 2007 on the treatment of banks' investments in insurers and issue a Discussion Paper on the impact on UK firms of the reviews of own funds/definition of capital being undertaken by the Commission and the Basel Committee.

In December we introduced rule changes following our consultation on implementing the **Reinsurance Directive**. During the year we will respond to applications for authorisation from insurers seeking to use the newly introduced Insurance Special Purpose Vehicle regime to manage their capital more efficiently.

The **Solvency 2 Directive** aims to establish a revised set of EU-wide, risk-based solvency requirements for insurers. Such requirements make prudential failure less likely – reducing the probability of consumer loss or market disruption. The Commission expects to publish its formal proposal for a Framework Directive by July 2007. We will continue to play an active role in the development of the proposals through our involvement in CEIOPS. We will also support the Treasury in negotiating the Directive.

Other EU initiatives

In 2007 we will chair the CEBS' **Convergence Task Force**. This will develop proposals for implementing the Francq Report recommendations on supervisory convergence in Europe. Together with similar initiatives in CESR and CEIOPS, this work will underpin the effectiveness of the Lamfalussy process.

As part of MiFID, the Commission is reviewing the transparency regime for the **trading of financial instruments other than shares** admitted to trading on a regulated market. Following consultation with the industry, our conclusion is that mandating transparency would not be proportionate for UK markets. We will seek to persuade the Commission that industry-led initiatives are likely to be a more effective means of addressing any transparency concerns. The Commission will publish its report in Q4 2007.

As part of the CRD, the Commission, with the involvement of CEBS and the European Central Bank, is reviewing the **large exposures** regime for banks and investment firms. We will seek to ensure that if a new regime for large exposures is introduced, it is developed in accordance with the principles of better regulation.

We will work closely with the Commission and other stakeholders, including the Treasury, industry representatives and CESR, to ensure the **code of conduct for clearing and settlement** is a successful alternative to legislation.

The negotiation of the EU proposals for reforming the rules and evaluation criteria for the **prudential assessment of acquisitions and increases of shareholdings** in the financial sector continues. The proposals intend to prevent Member States' supervisory authorities abusing their powers to refuse to approve potential acquirers. We will continue to support the Treasury's efforts to ensure the reforms are proportionate and achieve a balance between the needs of supervisory authorities to be confident that owners of financial institutions meet the necessary criteria, while maintaining an open market in Europe for mergers and acquisitions. We will play an active role in the development of the proposals through our involvement in the Lamfalussy Committees.

We support the Lamfalussy Committees' new initiatives on **cross-sectoral training** and expect to see tangible results during the course of the year.

International work

Globalisation – how we will deal with the global supervisory challenge

The global supervisory challenge is an issue for the regulatory community as a whole, but is particularly important for the UK given the international nature of our markets. The challenge arises from the fact that many firms and markets operate on a global basis while regulation and supervision are, for the most part, based on legislation which is national in scope. Supervision of global groups and activities needs to be effective: avoiding duplication and costs for firms that are likely to arise if supervisors fail to coordinate their efforts. This poses challenges both for the design of new regulation and the way in which we undertake our day-to-day supervision of global firms and activities. We have already made considerable progress in bringing together the most important supervisors for several global institutions to establish shared knowledge and regulatory responsibilities. We expect to make further progress in 2007/08 in our collaboration with other supervisors in supervision, enforcement and regulatory transaction cases.

In the **Basel Committee on Banking Supervision**, our key focus in 2007 will be the continued promotion of consistent implementation of the revised Basel 2 capital framework. Through our membership of the Accord Implementation Group, we will share our experience of Basel 2 implementation and develop a shared understanding of best practice, particularly in respect of

model validation, Pillar 2 and stress testing. We will also continue to address any issues arising out of the cross-border application of Basel 2.

We will seek to promote the development of revised standards in respect of the **definitions of capital** and **liquidity**. Through our co-chairmanship of the definition of capital sub-group and Bank of England co-chairmanship of the liquidity sub-group, we expect the UK to play a leading role in the development of these two critical areas of prudential regulation.

In 2007 we will chair the **International Association of Insurance Supervisors'** sub-committee on Solvency and Actuarial Issues. This committee will play a key role in developing international solvency standards, which should be broadly consistent with Solvency 2 Directive standards.

We continue to play an active role in setting international standards in the area of securities and capital markets through the **International Organisation of Securities Commissions** (**IOSCO**). We are working with the Secretariat and other members to ensure that IOSCO's workload is appropriately focused and that the industry is fully engaged; a number of initiatives in this area are expected over the next year. We have encouraged IOSCO, in its programme for the coming year, to focus on issues affecting intermediaries, including the regulatory oversight of intermediaries' adherence to the rules of market conduct. IOSCO will also develop principles for periodic disclosures by issuers and to improve the exchange of information between market regulators.

We chair the IOSCO sub-committee on the **valuation of illiquid and complex assets**. The Committee aims to produce a set of practical principles that investors can use as a guide. This will help address a priority risk identified in our FRO, that illiquid financial instruments are difficult to value and therefore raise operational and conflict-of-interest risks. IOSCO expects to publish the principles for consultation in April 2007.

On **International Financial Reporting Standards** (IFRS) we will continue to work on achieving convergence in global accounting standards. The focus of the work, in which we participate through our involvement on CESR, will be on achieving equivalence: an investor, when faced with financial statements prepared under different but equivalent accounting standards, should take the same investment decision.

We will also follow up on the changes we made to our prudential regimes in 2004/05, which were designed to accommodate IFRS and certain closely-related UK accounting standards. We will review the practical application of IFRS and consult on any proposed changes in Q4 2007.

Domestic policymaking

We will explore the nature and scale of any market failures which may arise from the non-disclosure of **contracts for difference** holdings in the UK market. If we identify failures we will consider the potential costs and benefits of the policy options for addressing them and publish our findings in Q3 2007.

We will review our policies on deducting deposit-takers' and investment firms' investments in their subsidiaries and associates and of **setting capital requirements at solo (as well as group) level**. We will consider the interaction between solo and group capital regimes to assess the real impact of our current policy. We will also work with firms to identify the factors driving group capital allocation in practice. Our review will begin in Q1 2007 and we expect to publish our findings in Q3 2007. Our objective is to have a method for supervising deposit-takers and investment firms that are members of groups under the Banking Consolidation and Capital Adequacy Directives, which balances the costs to the UK market with the need to protect depositors and investors and meets our Directive obligations.

Supervisory themes

During 2007 we will complete the roll-out of our **new risk-based approach** (ARROW II) to firms across the wholesale and retail sectors. A priority will be to integrate our risk assessment work with our work on firms' capital requirements. In banking, we will integrate ARROW II with Pillar 2 of the CRD and an assessment of liquidity arrangements, including the review of any global liquidity concession that may be granted to a non-UK headquartered firm. In insurance, we will integrate ARROW II with Individual Capital Adequacy Standards. We will also continue our work on corporate governance, focusing on the effectiveness of firms' arrangements in practice. In addition, we will complete our work on peer reviews to provide relationship-managed firms with a sense of where they stand relative to their industry peers (in terms of the risks that they pose to our statutory objectives).

To supplement our firm-specific work and to help inform our industry analysis, during 2007/08 we will carry out a number of thematic reviews. The most important of these for promoting efficient, orderly and fair markets are outlined below.

Banking

As outlined in our FRO, **unconfirmed trades** pose a risk to the stability of the markets. Firms have made considerable progress in addressing backlogs in credit derivatives. In 2007 we will extend our review of banks' operations to consider whether their controls and processes are robust and appropriate to the level of their trading, focusing on equity, interest-rate and commodity derivatives. Firms can expect increased supervisory focus until this issue is fully resolved.

We will review investment banks' **collateral management practices** to assess the extent to which firms can rely on collateral to mitigate market and credit risk exposures. This complements our work with US and other major regulators to improve our collective understanding of global firms' counterparty credit risk management policies, procedures and practices.

We will continue with our six-monthly **Prime Broker Survey** on the exposures to hedge funds of the main London-based banks that provide prime brokerage services. We will use this survey to identify large risk exposures and to work with firms so that their risk management systems can support the level of risk taken. We will also explore with the industry and other regulators whether this voluntary survey could be extended internationally.

In addition, we will work to ensure that market participants' procedures for handling **confidential information** are effective and that they stretch across the entire spectrum of instruments in which firms deal, including derivatives and debt instruments such as bonds and loans.

Insurance

Following our challenge in December 2004, the London market has, at the aggregate level, delivered a market-led solution to **contract certainty**. Firms who do not continue to ensure contract certainty can expect increased regulatory attention. We will also continue to press the case for contract certainty in other insurance centres, in Europe and North America in particular, so that this practice becomes the norm worldwide.

Participants in the commercial and wholesale markets have raised concerns about the lack of transparency of **commission** earned in the sale and intermediation of wholesale insurance contracts. We have been discussing this issue with the industry for some time but no industry-led solution has emerged. In 2007 we will analyse the extent to which lack of transparency is leading to customer detriment or impairing market efficiency and whether mandating commission disclosure would lead to benefits that outweigh the costs. If both the market failure analysis and the cost-benefit tests are met, and the market has still not come forward with a solution, we will consider regulatory intervention. We will publish the results of our work in Q4 2007.

In Q1 2007, we will publish the results of our further work reviewing the handling of **client money** by wholesale and retail general insurance intermediaries. Arranging adequate protection of client money is key for market confidence and for the fair treatment of customers in all markets. We will continue to take action against firms who fail to meet our requirements, including closing firms that show a persistent deficit in their client money accounts.

An assessment of controls on **underwriting strategy** is a core part of any risk assessment of an insurer. In addition to firm-specific work in this area, we are proposing to look into firms' approaches to cycle management for certain classes of business. We will be discussing approaches to setting risk appetite and underwriting strategy and, perhaps more importantly, the controls and information flows which firms have in place to monitor their actual performance against their stated strategy. This will help us to identify examples of good practice.

We introduced our **new risk-based capital adequacy** regime in 2005 and will complete our first reviews of the Individual Capital Assessments for all retail and wholesale insurance firms by the middle of 2007.

Asset management

We will continue to supervise **hedge fund managers** located in the UK, with a special focus on the 30 largest managers. To ensure that managers provide relevant and accurate information to their investors (so that they can make an informed investment decision), we will review whether they are disclosing the existence of side letters with material terms to investors. We regard this as a clear test of Principle 1 ('Firms must act with integrity'). We will also continue our work, and support IOSCO's initiative, on the valuation of illiquid instruments – one of the priority risks identified in our FRO and a key issue for hedge fund managers, given the significant presence of such instruments in many hedge fund portfolios (*see International work*).

New powers under the revised Undertakings for the Collective Investment of Transferable Securities Directive (UCITS III) and the growth of liability-driven investment, collateralised debt obligations and hedge funds, has resulted in **greater use of derivatives** by fund managers. During 2007/08 we will review firms' governance, systems and controls and risk management processes to assess whether firms are adequately managing their risks.

In 2007/08 we will also monitor firms' compliance with the rules we introduced in 2006 on limiting the use of **dealing commissions** by asset managers to execution and research. We expect improvements in the transparency of dealing commission and so in the accountability of fund managers to their clients.

Capital markets and financial exchanges

In Q2 2007, we will publish a Feedback Statement on the risks we identified in our 2006 **private equity** Discussion Paper. Firms can expect leveraged lending to remain a supervisory priority; firms' risk management processes should include regular scrutiny of material exposures to identify early warnings of changing market sentiments. We will consider repeating the leveraged buyout survey to understand better the impact on this market of the credit cycle. We will also carry out a fact-finding exercise to understand the issues and risks inherent in dealing with corporate defaults. In addition, we will enhance our supervision of private equity fund managers and the private equity activities of investment banks through a combination of firm-specific work and thematic reviews.

One of our key priorities is the prevention, deterrence and detection of **market abuse**. During 2007 we will launch a new transaction monitoring system, which will significantly enhance our capability in this area. We will continue to focus our resource on market abuse committed by institutions such as investment banks and hedge funds. We will carry out a mixture of surveillance and thematic work. This includes completing the project we launched last year to review the control over information in non-public mergers and acquisitions. We will also step up our efforts to work in partnership with the industry to reduce market abuse.

In our supervision of **market infrastructure providers** we will continue to monitor developments such as the potential consolidation and competition amongst infrastructure providers in the UK and globally. We will also continue to promote cooperation with foreign regulators to ensure appropriate regulation of cross-border market infrastructure providers. The new **Investment Exchanges and Clearing Houses Act** allows us to develop rules setting out notification obligations for recognised bodies that propose changes in regulatory provisions. We intend to develop these rules and publish a Consultation Paper in Q2 2007. In addition, we will review material changes in regulatory provisions proposed by market infrastructure providers as part of our implementation of this new Act.

In the Listing Function we continue to experience increased levels of activity, so we will devote additional resource to the review of prospectuses. We will also implement the outcomes of the review of the **listing rules for investment entities**; following consultations in 2006 on a more principles-based approach to determining eligibility for listing, we expect to introduce new rules in Q3 2007. In addition, in Q2 2007, we will publish a general update to the listing rules.

We are reviewing the risks that the **commodities markets**, including new types of participants in these markets (such as hedge funds, pension funds and proprietary trading houses) could pose to our objectives. In Q1 2007 we will publish an Occasional Paper setting out our views. We will use this work to inform the discussions with the exchanges and the market on the extent to which trading in commodity derivatives should be regulated under MiFID and CRD.

Financial stability

One of the priority risks identified in our FRO relates to **stress testing** and to our concern that in a period of low volatility firms should continue to assess what their position would be if extreme but plausible scenarios were to arise. In 2007/08 we will continue to examine the rigour and effectiveness of the stress testing adopted by our major institutions. The Tripartite Authorities – the FSA, the Bank of England and the Treasury – will also continue their work on **Factbooks**, so that information on key firms is quickly and easily available to the authorities in a crisis.

In 2006 we led a **market-wide exercise** on behalf of the Tripartite Authorities based on a flu pandemic scenario. A summary report setting out the main lessons learned was published in January. In Q1 2007 we will begin a series of workshops with participants to examine those lessons in more detail.

In Q3 2007, the Tripartite Authorities will repeat the **Resilience Benchmarking Project** undertaken in 2005. The purpose is to measure the resilience and recovery capabilities of the UK financial sector in the event of major operational disruption. We will compare the results with those of 2005. We will lead this project and publish a summary of the main findings in Q4 2007.

In 2007/08, we will also continue to play an active role in a number of international initiatives to strengthen **cross-border crisis management**. This will include: follow-up to last April's EU-wide crisis simulation exercise; contributing to initiatives on cross-border communications; and participating in the continuing work of the International Monetary Fund and the Joint Forum to raise awareness of the risks to the international financial system posed by a global flu pandemic.

Financial crime

As outlined in our FRO, the risk of financial crime is increasing. Our financial crime strategy for the next three years is to:

- gain a better understanding of the scale and incidence of financial crime and its impact on the UK and financial institutions;
- target poor performing firms and sectors; and
- encourage risk-based implementation of financial crime policy domestically and internationally.

Our financial crime strategy is underpinned by our intelligence capability, which we have strengthened both in terms of skill and depth of analysis. Our newly formed **Financial Crime and Intelligence Division** will continue to liaise closely with law enforcement agencies, trade associations and the industry, as well as government.

In Q1 2007, we will announce the results of our first **survey on financial crime**. We will use the results of this survey of firms and other stakeholders to inform our priorities and improve our work on financial crime.

As outlined in our FRO, **information security and high-tech crime** risks continue to rise as organised criminals' use of technology to obtain customer information becomes ever more sophisticated. This exposes consumers to an increasingly significant risk of fraud and identity theft. In 2007, we intend to examine in more depth the information security risks posed to firms and consumers.

Following last year's overhaul of our anti-money laundering rules and the Joint Money Laundering Steering Group's (JMLSG) review of their Guidance, the UK has in place the blueprint for a more **risk-based and proportionate approach to anti-money laundering**. This should lead to a more cost-effective regime which reduces the scope for criminals to launder money through the UK financial system but limits inconvenience to honest consumers. During 2007/08 we will carry out work to assess how the industry has implemented our new rules and the new JMLSG Guidance and give feedback.

On the international front, we co-chair the **Financial Action Task Force** (FATF) Working Group on evaluation and implementation. We are helping them develop and implement a risk-based approach to anti-money laundering and counter-terrorist financing, which we also expect to be relevant to implementing a risk-based approach in the EU under the Third Money Laundering Directive. In Q2 2007, the FATF expects to publish the results of its evaluation of the UK's anti-money laundering regime. The FATF's report will assess the extent to which our risk-based approach implements their internationally-accepted recommendations.

The Money Laundering Regulations 2007 will bring the requirements of the **Third Money Laundering Directive** into UK law. From 15 December 2007 our responsibilities will extend to a wider range of firms and activities than we currently regulate. We will be responsible for supervising the anti-money laundering controls of certain financial institutions conducting activities such as leasing and trade finance. We will also be the anti-money laundering supervisor for authorised firms that are acting as money service businesses or trust and company service providers.

2 Helping retail consumers achieve a fair deal

Introduction

One of our **key priorities** is to make the retail markets function more effectively and, as a consequence, help retail consumers achieve a fair deal. To achieve this aim we focus on what we consider to be the four key features of effective retail markets:

- capable and confident consumers;
- clear, simple and understandable information available for, and used by, consumers;
- soundly managed and adequately capitalised firms that treat their customers fairly; and
- risk-based and more principles-based regulation, through firm-specific and thematic supervision and policy.

Our move towards a **more principles-based approach** to regulation will bring benefits for firms as well as consumers. It will provide firms with greater flexibility to determine how best to run their business and how to deliver fair treatment to customers in a way which is consistent with commercial objectives. It will also enable firms to compete and innovate more effectively in areas such as product design and customer service.

As outlined in our FRO, the distribution of retail investment products and the reputation of the market raise concerns about the sustainability of the sector and the fair treatment of consumers.

Alongside our other initiatives described below, our **Retail Distribution Review** will consider whether there are additional measures that could enable the market to operate more efficiently.

Retail Distribution Review

The aim of our retail distribution review, launched in June 2006, is to identify and address the root causes of problems that continue to persist in the retail investment market. It will consider distribution by banks, life insurers, financial advisers, building societies, fund managers and platforms and will focus on the following themes:

- the sustainability of the sector;
- the impact of incentives;
- professionalism and reputation;
- consumer access to financial products and services; and
- regulatory barriers and enablers.

We aim to publish a Discussion Paper in Q2 2007 setting out our analysis, our initial conclusions and commenting on potential solutions.

It is likely that the Discussion Paper will result in further consultation including on the costs and benefits of any change. Our preference is for an industry-led solution, so we have set up industry groups to work with us on this.

In parallel, we are looking at particular industry developments that might affect retail distribution. One example is our work on **wrap platforms**, which are systems that advisers can use to view and administer clients' portfolios. We want to make sure that wrap platforms are used in ways that improve the services customers receive; with this in mind we plan to publish a Discussion Paper in Q2 2007 looking at the risks and opportunities they present.

Capable and confident consumers

One of the **priority risks** identified in our FRO is that many consumers lack the financial capability to make effective decisions about their money: the baseline survey that we published in 2006 demonstrates the extent to which the nation's financial capability needs to be improved. Over time, improving people's financial capability will contribute to more effective and efficient retail markets, reducing the need for regulatory intervention and enabling firms to develop practices that better suit the needs of their customers.

We will continue to lead the **National Strategy for Financial Capability**. We will work with our partners to improve the financial capability of consumers at various points in their lives. Following careful piloting, and taking into account the results of our survey of current levels of financial capability in the UK, our programmes focus on: children in schools; young adults in universities and further education colleges; young adults not in employment, education or training; employees in their workplace; and new parents.

We aim to reach at least ten million people in the five years from 2006/07 – 2010/11 and, to do so, we will scale up these programmes significantly. To achieve this, we will spend £17.1m in 2007/08 and £15-£20 million in each of the following years up to 2010/11 (compared to £9.7m in 2006/07). In particular, by the end of the year, we will:

- deliver our schools programme, *Learning Money Matters*, to 310,000 children in a further 1,200 secondary schools in England and in 75 secondary schools in Scotland, Northern Ireland and Wales;
- provide the *Money Doctors* toolkit to a further 31 universities (bringing the total to 50) and make the remaining 118 universities aware of the availability of the toolkit;
- work with ten early developer further education colleges, both to develop the *Money Doctors* toolkit for that audience and to examine how best to embed personal finance education in their curricula;
- provide training to youth workers in 50 major organisations that provide services to young people not in employment, education or training;
- depending on the outcome of a pilot project which we are currently undertaking, deliver the *Parent's Guide to Money* to 20,000 new and expectant parents;
- provide *Make the Most of Your Money* materials to a further 520,000 employees, 40,000 of whom will attend seminars in their place of work (bringing the totals reached to 720,000 and 55,000 respectively); and
- work in partnership with intermediaries to provide straightforward money advice to groups of consumers of priority need.

We welcome the establishment by the government of a feasibility study to design, research and test a national approach to the delivery of money advice.

We will repeat the **financial capability baseline survey** in 2010 and take into account the results of that, together with the success of our programmes, to determine our strategy for 2011/12 and beyond. We welcome the recent publication by the government of its long-term strategy on financial capability, which complements our National Strategy.

Although we have no statutory responsibility for addressing **financial exclusion** our work can affect this issue, in particular through the National Strategy described above. In addition, we will continue our work with the credit union movement, where our proportionate regulation is key in enabling these institutions to help those excluded from mainstream financial services. We also recognise the contribution Islamic financial institutions make to financial inclusion and will continue to promote a level playing-field between conventional and Islamic institutions.

Clear, simple and understandable information

Clear, simple and understandable information is crucial in helping consumers become more capable and confident about making financial decisions. Our work has two main strands: providing clear and impartial information direct to consumers through our dedicated consumer website and hard copy publications; and ensuring that the information which firms give their customers meets our standards.

Over the next three years we expect the number of visits to our consumer website, now called *Moneymadeclear*, to increase from two to four million a year. We will continue to encourage advice agencies and regulated firms to promote our **interactive online tools**, the *Financial healthcheck* and *Debt test*. These tools are particularly important given the priority risk identified in our FRO, that a significant minority of consumers could experience financial problems because of high levels of borrowing.

During 2007/08 we will continue our programme of **advertising campaigns** promoting our website and hard copy publications as a trusted source of clear, impartial information. We will encourage consumers to use this information to help them get a head start when making financial decisions. Our first campaign starts in Q1 2007 and will focus on promoting *Moneymadeclear*, specifically the information on insurance. We will continue promoting this website during the second half of the year and in Q1 2008. These campaigns will target particular groups of consumers and feature our interactive tools, including our online tables which help consumers compare products and shop around.

We will also revise our **hard copy publications**. The first revised publications will be available at the end of Q2 2007. We will improve the way we distribute these publications so that the right information is available to consumers at the right time.

We will also continue to work with the Department for Work and Pensions and the Personal Account Delivery Authority to consider how consumer information on **Personal Accounts** can be incorporated into our wider financial capability work.

We will continue our work to improve standards in **financial promotions** and to reduce the number of promotions presenting a high risk to consumers. We will increase our monitoring of promotions across a range of media, focusing on those that pose the greatest risk to consumers – for example, internet promotions, promotions for mortgages, reversion plans, venture capital trusts, and self-invested personal pension schemes. We will publish the findings from our thematic work, with examples of good and poor practice, and take supervisory action where appropriate. This may include: asking firms to withdraw or amend promotions; investigating firms' systems and controls; or initiating remedial action or formal enforcement investigations. We also continue to work closely with the Advertising Standards Authority and the Office of Fair Trading to share experience and to maintain coherence and clarity of approach. In addition, we will work with firms so that there is a smooth progression to the new financial promotions regime in November 2007.

We will also continue to work with the industry on **point-of-sale product disclosure** to reduce the likelihood of consumers buying unsuitable products. As part of our work on simplifying our conduct of business rules and implementing MiFID, we are proposing new, more principles-based rules (*see Supervisory themes and policy priorities*). In addition, in Q3 2007, we will publish examples of good and poor practice to support our supervisory and thematic work to improve the quality of 'keyfacts' documents.

We believe that our new rules, for both financial promotions and point-of-sale disclosure, will give firms greater scope to develop consumer information that explains the features, risks and benefits of a product in a more appropriate, straightforward and understandable way.

Soundly managed and adequately capitalised firms who treat their customers fairly

Treating Customers Fairly

Treating Customers Fairly (TCF) is an example of our move to a **more principles-based approach** to regulation. The standards we require the industry to meet as a minimum are not new – they are those described in our Principles for Businesses. Rather than introducing new rules and guidance that limit the ways in which firms' senior management can meet our standards, we have adopted an outcomes-based approach. We have used a range of methods to illustrate what TCF means in practice – for example, case studies, examples of good and poor practice, a self-assessment tool for smaller firms and a statement on the respective responsibilities of providers and distributors, which we will finalise in Q2 2007.

We recognise that it is important that the **status of our materials** is clear and our approach to applying these standards is consistent and predictable. We also understand that firms and our own people can find the more principles-based approach demanding. For example, there are practical challenges arising from the change to a shorter Handbook supported by a variety of information sources. We will do further work this year to improve the way we organise our website and other materials so that they are easy for firms to access and understand. We will also continue to consider whether consultation and other processes (e.g. cost-benefit analysis) are appropriate for any new materials that we issue on TCF.

We have published a suite of new web pages aimed specifically at **small firms** to help them understand what more principles-based regulation, and in particular TCF, means for them. Small firms can now use these pages to keep themselves updated with developments and, importantly, to identify and understand the actions they should be taking to ensure that they meet their TCF obligations.

Our TCF initiative challenges firms' senior management across all sectors to review how they treat their customers and to make changes where they find practices which may lead to unfair outcomes for consumers. We want to see a retail marketplace characterised by the following **outcomes for consumers**:

- consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;
- products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;
- consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;
- consumers receive suitable advice;
- consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and
- consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

TCF will continue to be a **supervisory priority** throughout 2007/08. We expect all firms to be implementing TCF in a substantial part of their business by the end of March 2007. We will publish our assessment of the extent to which the deadline has been met across the industry and set out our approach to firms who are making less progress than we expect.

We will also continue to challenge firms on the **management information** they use to satisfy themselves that their customers are being treated fairly. We expect to see real improvements during 2007/08. In addition, we will carry out work to measure how far progress is being made towards achieving the consumer outcomes. Working with industry and consumer bodies we are developing a **range of indicators** we can use.

Our work to date has highlighted a potential gap between the commitment shown by senior management in firms to treat their customers fairly and the outcomes at the consumer interface with the firm. So we will be looking at **corporate culture**, including organisational and management arrangements that may encourage or inhibit the delivery of senior management aspirations throughout the business. We expect to publish examples of good and poor practice in Q3 2007.

We see some deficiencies in firms' standard-form **consumer contracts** as an example of how some firms are failing to treat their customers fairly. We will continue to use our powers under the Unfair Terms in Consumer Contracts Regulations to help ensure that firms are drafting fair contract terms and administering them fairly.

We will continue to take enforcement action, including on the basis of principles alone, where we find significant actual or potential consumer detriment.

We will assess whether the market meets the needs of **older consumers** and whether the current regulatory structure acts as a barrier to the development of appropriate products and services. We will discuss the issues with a wide range of stakeholders and will publish our findings and recommendations in Q4 2007.

Towards the end of 2007 we will consider the impact of **climate change** on the retail and wholesale markets. Among other impacts on the economy and financial markets, climate change could have implications on consumers' ability to access insurance and other financial products in areas that are prone to flooding, windstorms or soil erosion. Any action we plan to take will be included in our Business Plan for 2008/09.

Capital adequacy

We introduced our new **risk-based capital adequacy** regime for insurers in 2005 and have reviewed the Individual Capital Assessments of 91% of the life insurance market and nearly 98% of the general insurance market (as a proportion of total liabilities). We will complete all first reviews by the middle of 2007. In the second half of the year, we will focus on second reviews. In particular we will review the extent to which firms are embedding the new regime into their wider risk-management practices and using the framework as part of their strategic decision making processes.

In parallel with the Retail Distribution Review, we will review the role of **capital requirements for personal investments firms** and test the efficiency of these and other prudential requirements such as personal indemnity insurance in mitigating market or regulatory failures in this sector. We will consult on any proposed changes in Q1 2008.

We will also continue to take a strong interest in the **lending strategies** of retail firms, particularly in those firms expanding their lending into areas where they have little or no past experience. In addition, we will maintain discussions with the larger retail banks over changes in lending criteria and trends in impairment levels.

Supervisory themes and policy priorities

Reform of conduct of business rules

We are making a series of changes to simplify our **conduct of business regime** for investment business and, at the same time, to implement MiFID (*see Section One*). Our new rules will be consistent with our move towards a more principles-based approach, focusing on the outcomes we wish firms to achieve rather than on prescriptive rules. We plan to complete our consultation process in Q2 2007 and will publish the final text of the new Conduct of Business Sourcebook in Policy Statements in Q2 and Q4. We will work closely with industry stakeholders as they prepare for implementation on 1 November 2007.

Mortgages

In 2007/08, we will continue to focus on the higher risk areas of mortgage sales.

We will review the **sub-prime mortgage sector** to consider whether compliance has improved following the work we undertook in 2006. This review will go further than the original project by not only reviewing advice but also affordability (by following cases through from the brokers to the lenders to assess their lending policies).

On **affordability of mortgages** we will carry out further work so that consumers are aware of the risks and that firms communicate those risks appropriately. We will monitor lenders' responsible lending policies to review whether they are catering effectively for the interest-only market and we will seek to identify and publish examples of good practice in lenders' communications with these customers. We are also gathering information to assess whether sales of mortgages extending into retirement give rise to consumer detriment. We will publish our findings and any proposed action in Q2 2007.

On equity release, we will undertake two key strands of work, on **lifetime mortgages** and on **home reversions**. Our work on lifetime mortgages will focus on improving the standards of sales by firms that sell only small volumes of these products relative to their overall business. On home reversions, which we will regulate from April 2007, we will help firms selling this product to understand our requirements. We will also publish new consumer education materials on home reversions and home purchase plans to raise consumer awareness.

Last year we published the results from the first stage of our **mortgage effectiveness review**. The purpose is to consider whether the regime is delivering the intended benefits for consumers. The second stage, starting in Q2 2007, will focus on sectors of the mortgage market where the potential risk to consumers is greater, for example lifetime mortgages and the sub-prime market. We will also consider whether consumers are treated fairly over the life of their mortgage, including when they go into arrears. We expect to publish our results in 2008. We will also work with stakeholders to identify areas of the rules that we could simplify or move towards a more principles-based approach.

In 2007 we expect the European Commission to publish a **White Paper on mortgages**. A costs and benefits study prepared for the Commission suggests it would bring little benefit to the UK but would impose significant costs. We will continue to encourage the Commission to adopt a better regulation approach and intervene only if the market failure and cost-benefit tests are met, and no other non-legislative solution can be found.

Financial Advice

In 2007 we will continue to review how effective **depolarisation** has been in improving consumers' access to a wider choice of products. MiFID has presented a significant challenge to our review because the disclosure rules in our depolarisation regime are super-equivalent to Directive requirements. As a result, we will focus on assessing consumer understanding of the Initial Disclosure Document and the Menu. We will publish the results of our research and consult on any proposed changes in Q4 2007. This work will also be informed by the evidence from our benefits of regulation work, outlined below.

In Q2 2007 we will publish the results of the research into the **benefits of our rules** on suitability letters and the Menu. This is in response to the June 2006 report on the costs of regulation, which identified these rules as relatively expensive for some firms. We have already consulted on a proposed simplification of the current suitability letter requirement as part of our reforms to our conduct of business rules. Any further changes we make will be reflected in the final version of our new conduct of business rules. In the case of the Menu, should any changes be necessary, they are unlikely to come into effect before the outcome of our depolarisation effectiveness review.

Our **basic advice** regime is designed to provide a simpler, quicker and lower-cost form of advice for consumers interested in purchasing the government's suite of 'stakeholder' savings and investment products. In 2007 we will review whether the regime is proportionate for firms and provides an appropriate degree of consumer protection. We are consulting on the remit of the review and will publish terms of reference in Q2 2007 and complete the review in Q2 2008.

We will also seek to assess the **suitability of recommendations** made to clients seeking advice. We recognise the difficulties in this and will work closely with industry and consumer representatives to develop a method that is robust, replicable and proportionate. If we are able to do this, work will begin in 2007. We will use the outcomes of this work to inform our allocation of resources and improve outcomes for consumers. The work will also establish a baseline for assessment of progress against one of our TCF objectives; that where consumers receive advice, the advice is suitable and takes account of their circumstances.

Insurance

General insurance

Our experience of general insurance regulation confirms that there are greater risks to consumers for **personal protection products**, such as payment protection and critical illness cover, than from other general insurance, such as **household** and **motor policies**. We will review whether our rules provide sufficient consumer safeguards for the sale of protection policies. We will also examine whether our rules deliver benefits to consumers taking out products such as household and motor insurance, and whether there is a case for deregulation of these products (subject to the constraints imposed by EU directives). We will publish a report on our review in Q1 2007, consult on any proposed changes to our rules in Q2 2007, and introduce any changes in Q4 2007.

We will carry forward work to deliver a significant improvement in sales standards in the **payment protection insurance (PPI) market**. This will include:

- visits to over 100 firms, including some already visited and a sample of new firms;
- targeting firms who sell PPI as the third element in a transaction;
- ensuring industry initiatives to improve selling practices are delivered;
- further enforcement action; and
- in recognition of the wider structural issues that exist in the PPI market, further work with the competition authorities.

We will report on the outcomes of this work in Q3 2007. In addition, the review of our general insurance conduct of business rules is examining whether changes to our rules can help achieve better outcomes for consumers in the PPI market. We are also looking at the feasibility of adding PPI to our online tables, which help consumers compare products and shop around.

Life insurance

As in previous years, **closed funds** remain high on our agenda. A key focus for us in 2007/08 is to continue to challenge the senior management of life insurers who have closed with-profits funds on a number of issues, including investment strategy, policyholder information, outsourcing arrangements, and management information.

We also plan to do further work so that **with-profits policyholders** – in both open and closed funds – receive clear and accessible post-sale information that enables them to take informed decisions about whether to keep or surrender their policy. We will also consider the extent to which good quality advice on with-profits is available to policyholders.

In Q1 2007 we will pilot a review of the governance standards applied by insurers in the **oversight of intra-group investment management services**. We will consider how insurers define the requirements and expectations of their fund manager and how they monitor performance against those requirements and expectations. We will also consider how insurers manage potential conflicts of interest that may arise, for example under-performance, particularly where this may affect shareholder profits/dividends paid up to the group. We will use the results of our pilot work to decide whether any further work is necessary.

In addition we will continue to focus on strategy, governance and financial strength in **smaller life insurance firms**. This builds on work we have already done with these firms to strengthen capital adequacy and to improve the treatment of policyholders.

Asset management

Under **UCITS III**, the retail market is opened up to a much broader use of derivative instruments. During 2007/08 we will work closely with firms to address the risks arising from this development, including the adequacy of firms' risk management practices and the disclosure of derivative holdings to customers.

We will also consult on reforms to eligible assets for UCITS schemes, taking into account the European Commission's definition of eligible assets.

In Q1 2007, we will consult on other proposed changes in the rules for collective investment schemes: allowing the creation of **funds of unregulated schemes**, where the underlying assets of the fund of funds is made up of unregulated schemes; and changes to the **permitted links regime**. Allowing funds of unregulated schemes may lead, among other products, to the creation of on-shore funds of hedge funds (subject to taxation issues being resolved). This will open up the retail market to a wider range of alternative investment products. The changes proposed to the permitted links regime are designed to remove the inconsistencies between the existing rules for unit linked insurance and the rules for collective investment schemes.

Banking

We will work closely with the **Banking Code Standards Board** on the extent to which consumers are being treated fairly in the area of deposit-taking. We will develop a Memorandum of Understanding to set out our respective responsibilities and to minimise regulatory underlaps or overlaps. We will also contribute to the review of the Banking Code – the industry's own code of conduct in this area.

Retail banks are experiencing resistance from consumers and scrutiny from the public authorities in their **charging and marketing practices**. We will develop our understanding of the implications of potential changes to banks' business models in response to this pressure.

Towards the end of last year, the Economic Secretary announced a Treasury review of **credit union and cooperatives legislation**. We expect to be actively involved in providing advice to the Treasury on both matters.

We will also assist the Treasury in its consideration of statutory funding limits for **building societies**, which will include reviewing the position of building society members' savings.

The **Payment Services Directive** is currently under negotiation and may be finalised in 2007. We will consult as necessary should the government decide to give us responsibilities under this Directive.

Small retail firm supervision

About 18,000 of the firms we regulate are **small retail firms** and some of our supervisory priorities are specific to them. In line with our risk-based approach we collect and analyse data from these firms and use it to identify breaches of our rules or new and emerging risks. In 2007/08 we will increase the extent to which we use information provided by firms on the practices of other firms in their sector. We will also seek to ensure that our thematic work covers significant numbers of those firms which otherwise have no or little contact with us.

We will focus on four key themes in small firms:

- how firms that offer advice identify, manage and mitigate risks that customers are not treated fairly;
- improving regulatory compliance in the secondary general insurance market (*see Insurance*);

- the extent to which credit unions have adopted practices that properly reflect the Joint Money Laundering Steering Group Guidance Notes and the recent changes in our rules (*see Section One*); and
- the quality of Retail Mediation Activities Return (RMAR) submissions.

Our work on how firms that offer advice identify, manage and mitigate risks that customers are not treated fairly has several strands. We will assess the extent to which firms have improved the way they give advice on investment and mortgage products, comparing performance against a baseline established in 2006. We will also assess the extent to which networks have controls in place to ensure that their Appointed Representatives' customers are treated fairly.

We will continue to help small firms to complete their RMAR, building on experience to date. In addition we will increase our monitoring of the accuracy of submissions. As part of our work to improve our business capability and effectiveness, we will also continue our review of the RMAR and introduce changes as required (*see Section Three*).

In addition, we will introduce further measures to improve our communications and promote the use of good and poor practice and case studies to make it easier for small firms to do business with us (*see Box in Section Three*).

Pensions

From Q2 2007, we will regulate all personal pension schemes including **self-invested personal pension schemes** (SIPPs). We will liaise closely with the Association of Member-directed Pension Schemes and other trade bodies to help firms implement our new conduct of business rules.

We will continue our work on contracting-out of the **state second pension** (S2P). This work is examining whether consumer detriment arising as a result of past mis-selling of Appropriate Personal Pensions (policies used to contract out of the state second pension) would justify regulatory action. We have not identified any widespread evidence of mis-selling, although concerns may arise where sales were made outside broadly accepted age parameters. Before we take our decision on this particularly difficult subject we will fully test our analysis to ensure it is robust. We will take into account issues of consumer protection, consumer awareness, market confidence and proportionality in reaching a decision. We have consulted widely with the industry and consumer groups and will publish the outcome of our work in Q2 2007.

A White Paper, published by the government in December, includes proposals for a **national pension scheme**. Personal accounts will be treated as occupational pension schemes and the government expects that the regulatory regime will be based on the existing framework. We will continue to work with the government to determine the regulatory risks. The Department for Work and Pensions has also announced a review of the institutions involved in the regulation of pensions, the scope of which includes the boundaries between the FSA and The Pensions Regulator. We will work with the government on this.

FSA-OFT Joint Action Plan

This is a continuing programme of work and, in November 2006, we agreed to find further opportunities for **better joint working**. The aim is to reduce the administrative burden on firms, improve the way we make information available to consumers and deliver risk-based regulation.

During the year we will involve the OFT in our reviews of depolarisation and the retail distribution system. In addition, we will begin a programme of secondments so that people in both organisations develop a deeper practical understanding of their respective roles and responsibilities. We will also look for further opportunities to share processes and systems and, most importantly, build on the enhanced communications between the two organisations.

Financial Services Compensation Scheme and Financial Ombudsman Service

In 2006 we published a Discussion Paper proposing reforms to the funding of the **Financial Services Compensation Scheme** (FSCS). In response to concerns raised about the fairness, proportionality and sustainability of the present funding arrangements, the paper outlined a number of possible options for the future funding of the FSCS. Our aim is to design funding arrangements which are sustainable and which share the cost of compensation between regulated firms as fairly as possible. We will publish a Consultation Paper in Q1 2007 proposing new funding arrangements, which we aim to put into effect in April 2008.

Last year we also published a joint Discussion Paper with the **Financial Ombudsman Service** (FOS) which considered a wide range of options for the future funding of the FOS. Based on the feedback we received, we are carrying out further work on some of the options to analyse how they would operate in different scenarios. We will publish further work in 2007.

Other Handbook reviews

As part of our commitment to better regulation and our move towards a more principles-based approach to regulation, in 2007/08 we will review a number of our sourcebooks.

In our review of the **Client Assets Sourcebook** (CASS), our aim is to produce a unified set of rules with appropriate differentiation for particular sectors, while maintaining necessary consumer protection and meeting the requirements of relevant European directives. Within these parameters, we will remove rules where justified by cost-benefit analysis and will take opportunities to reduce the administrative burdens on firms. We will start our review in Q3 2007 and expect to publish our proposals in Q1 2008.

In Q4 2007 we will implement changes to our **Approved Persons regime**. We published a combined Feedback Statement and Consultation Paper in 2006 on reforms to the regime, which are designed to implement a more principles-based approach and the requirements arising out of MiFID (*see Section One*). With two exceptions (deletion of the annual significant management function report and the sole trader function) we plan to implement these changes on 1 November 2007, in line with MiFID.

In 2007 we will also complete our review of the **Training and Competence Sourcebook** to ensure it is consistent with our more principles-based approach to regulation. In Q1 we will publish a Consultation Paper setting out our proposals on the requirements for retail business, followed by a policy statement in Q3. Any changes, including those we have already consulted on for wholesale business, will come into effect on 1 November 2007.

3 Improving our business capability and effectiveness

Introduction

The third of our strategic aims is improving our business capability and effectiveness. This encompasses not only the investment we make in our people, our internal processes and infrastructure, but also making it easier for firms, consumers and other stakeholders to do business with us. Although this is an aim to which the whole organisation is committed, our work in this area is led by the Regulatory Services Business Unit.

One of the core activities of this Business Unit is to provide **services to external stakeholders**. For consumers, we run a contact centre which answers queries about the financial services regulatory system and our role and activities, and distributes our extensive range of guides to them on request. The Business Unit is also responsible for handling most of our regular interactions with firms, which include incoming correspondence and calls to the Firm Contact Centre, applications for waivers, variations of permission, cancellations, changes of controller and payment of fees. Our strategy continues to be to invest in improving our technology and processes to provide more accurate and timely responses, improve productivity and reduce running costs.

It is clear from the feedback we receive and from the 2006 Practitioner Panel survey that firms attach great importance to their experiences of dealing directly with us. We will continue to introduce **new service standards** and **customer satisfaction measures** where appropriate, and will look to benchmark our performance against industry best practice.

Our aim is to make it easier for firms and consumers to help themselves and to reduce the time and effort which firms need to spend dealing with us. The more we achieve this aim, the more efficient will be the use of resources by our stakeholders and us.

Helping small firms do business with us

We summarise in the following box measures that we believe are of particular benefit to **small firms**, and new initiatives which we hope will make it easier for small firms to do business with us.

Making it easier for small firms to do business with the FSA

What is currently available:

- A **Firm Contact Centre** that handles queries from authorised firms about regulation and the Handbook.
- **Regional visits**, with surgeries to enable firms to discuss topical issues with an FSA representative.
- **Roadshows for small retail firms**, to feed back on current supervisory issues, including findings from our thematic work.
- **Industry Training** sessions designed and delivered by FSA people across the UK. Distance learning materials including audio and computer-based products.
- **Liaison with trade bodies** to help them keep up to date with what is happening in specific sectors and to consult early on proposed changes.
- **Tailored handbooks** containing only the rules relevant to certain types of firms and the ability to **build a personal handbook**.
- **Handbook Guides** (for example, for IFAs, mortgage and general insurance intermediaries), to help firms in those sectors find the rules relevant to them.
- **Key rules** for general insurance intermediaries, to help firms understand the requirements that apply to them in their day-to-day activities.
- A **section of our website** dedicated to small firms, with specific pages for different types of firm (including a new section for motor retailers).
- **Treating Customers Fairly** web pages with a built in self-assessment tool and examples of good and poor practice.
- **Interactive online tool** to help firms build their own **Initial Disclosure Document**.
- Self-assessment tool for financial adviser firms to work out their **anti-money laundering responsibilities**.
- Guide to how and why we carry out **mystery shopping**.
- **'Firms Online'** service on our website, allowing electronic submission of regulatory returns, along with forms to notify us of changes to, for example, static data (eg. address).
- **Build your own application packs** tailored to individual applicants, so that firms are presented only with the questions that are relevant to them.
- An **online Fees Calculator**, to help firms budget for the year ahead.
- A **fees section** on our website including answers to the most common questions.
- The option of paying **fees** to the FSA, FOS and FSCS **by instalments**.
- A **single invoice** showing all direct regulatory costs in one place.
- **Targeted electronic distribution** of FSA material, on request, via our website.
- Help for small firms on implementing **MiFID** and the **CRD**.

New initiatives for small firms in 2007/08:

- Targeted communication including case studies to explain what **more principles-based regulation** means for small firms.
- Helping small firms **engage in consultations** on policy developments, for example by distributing sector specific consultation forms at roadshows to ask for firms' views on the key proposals affecting them.
- Improved **website navigation** to include A-Z index and intuitive headings.
- Improvements to the structure of the **small firms web pages** to enable firms to chose the level of detail in which to view the requirements that apply to them.
- Introduction of **Key Rules for mortgages**, to help firms understand the requirements that apply to them in their day-to-day activities.
- Piloting the use of new **audio and visual** communication channels.
- Running training **workshops and roadshows together** to reduce cost and improve the accessibility of training for firms.
- Training and roadshows for **motor retailers**.
- Web-based tool to help small firms calculate **FOS compensation awards**.
- Continued review of the **Complaints Return** and the **RMAR** to consider whether the data we receive is appropriate and whether the guidance and training we provide could be improved.

People

The success of our regulatory strategy depends on the **effectiveness of our people**. We must attract, reward, manage and develop the talent we need to deliver a more principles-based approach to regulation. Our people will need to be able to explain clearly what our principles are designed to achieve and to exercise judgement in considering the different ways in which firms can comply with our principles. Building on the success of our existing relationship management model, we will introduce a new enhanced level of relationship manager. The new role will be carried out by staff with high relationship management ability, commercial awareness and in-depth market knowledge. They will be responsible for our most complex relationships with firms.

Our aim is to create an environment in which our people can deliver the **highest levels of performance and productivity**. To achieve this we will invest in management development and, in particular, in extending our use of coaching and feedback.

To help our people deliver a more principles-based approach to regulation we will make a **significant investment in higher quality, more rigorous training**. As well as providing training on what a more principles-based approach to regulation means in practice for frontline staff, we will develop sector-specific training programmes and enhance the interpersonal skills training we offer. We will also increase our sponsorship of professional qualifications. In addition, we will continue to use outward secondments so that people in key areas can apply up-to-date industry expertise. In addition, during 2007/08, we will provide one-off training to support the regulatory changes arising from the implementation of MiFID and CRD.

Throughout 2007/08 we will continue to develop an employment proposition which enables us to **attract and retain talented people**. Our aim is to offer a career path within, and beyond, the organisation and a reward package that incentivises and rewards our high performers. In this context, in 2007 we will review our graduate programme so that we continue to attract and develop a base of high quality graduate talent.

Office accommodation

To support our people's effectiveness and efficiency at work, we plan to maximise the use of our main office accommodation in 25 The North Colonnade (25TNC). We will:

- refurbish and upgrade the 11 office floors within 25TNC to create a modern, flexible, and dynamic working environment;
- upgrade aspects of our IT infrastructure (e.g. data and voice networks and new desktop PCs); and
- replace elements of the building infrastructure such as the cooling towers, as required under the terms of our lease.

We anticipate that all of our London-based staff will be accommodated in 25TNC by the end of June 2008.

Technical infrastructure

We will continue to **invest in the technology** we need to achieve our three strategic aims, focusing on improving efficiency and resilience. In 2006 we entered into strategic alliances with three IT development partners (Capgemini, Tata Consultancy Services and Xansa), who will help us to deliver this technology more efficiently and cost effectively. A number of the projects we are working on with these partners are mentioned in this Plan, including the Integrated Regulatory Reporting programme; our new transaction monitoring technology; and the delivery of new electronic application and notification forms.

In Q1 2007 we will outsource our IT infrastructure services to Fujitsu and our application management services to Xansa. By April 2007 we will have completed the transition to our new suppliers. This will enable us to be more flexible to changing business needs whilst improving our overall IT capability and effectiveness. It will also help us to achieve an 'Industry Standard' IT function by September 2007, with further transformation work planned to deliver a 'Best in Class' IT function the following year.

Knowledge management

We require the firms we regulate to submit regular data on compliance and performance. We also receive information from a range of other sources, including consumers, other regulators in the UK and overseas, and Members of Parliament. As a result, we hold **huge volumes of information**; the challenge is to use this more efficiently and effectively. More specifically, for more principles-based regulation, it will be critical that we have full access to information across the organisation to ensure that we give consistent guidance. One of our first priorities will be to develop more **comprehensive data search tools**. Making information available to our people through a common system will also support our move towards a more modern working environment, enabling our people to access information flexibly, in line with practice in, for example, professional service firms and the largest firms we regulate.

Integrated Regulatory Reporting (IRR)

IRR is already in place for a large number of firms (mainly Mortgage and General Insurance intermediaries and retail investment advisers) through the submission of the Retail Mediation Activities Return (RMAR), the Mortgage Lending and Administrative Return (MLAR) and the Complaints return. Banks, building societies, insurers and investment firms participating in the mortgage or retail mediation markets will also have to complete relevant parts of the MLAR and/or RMAR from 1 April 2007.

Following the completion of our review of the reporting regimes we inherited from previous regulators, we will **introduce IRR for all firms in the course of 2007/08**. The new reporting requirements will be based on regulated activities rather than firm types.

The table below sets out the **main changes in reporting requirements** over the next two years. We also indicate which submission methods will be used as we move towards the long-term strategic reporting platform.

Key start dates	Submission method	Firms affected
1 January 2007	Key Data via new Early Reporting System Existing reporting via current methods	Banks, building societies (Credit institutions), and CRD investment firms (BIPRU investment firms) submit key data in addition to existing financial returns.
1 April 2007	Firms Online system	Credit institutions, insurers and investment firms participating in the regulated mortgage market, insurance mediation or retail investment mediation submit the non-financial sections of the RMAR and/or MLAR.
6 April 2007	Firms Online system	Advisers on self-invested personal pension schemes (SIPPs) submit RMAR and Complaints (if not already due to other mediation activities). Newly authorised operators of personal pension schemes (including SIPPs) submit Complaints return and, if they also act as advisers, they submit non-financial RMAR (plus transitional manual submission of annual statutory accounts).
1 October 2007	Firms Online system	Firms who carry out only new Home Reversion or Home Finance activity submit MLAR and/or RMAR.
1 November 2007	New Early Reporting System Existing reporting via current methods	MiFID comes into effect. Exempt CAD (Capital Adequacy Directive) firms move to new financial reporting rules with key data submitted in addition to existing financial returns (but not submitted until after 1 January 2008).
1 January 2008	New Early Reporting System	Credit institutions and BIPRU investment firms stop submitting existing financial returns/key data and move to most CRD-related reporting.
1 February 2008	Method of reporting to be confirmed	Newly authorised operators of personal pension schemes (including SIPPs) submit new financial data items.
1 January 2009	Strategic reporting platform	Credit institutions and BIPRU investment firms submit all new data items. Non-BIPRU investment firms and exempt CAD firms submit all new data items and stop reporting key data and existing financial returns. Newly authorised operators of personal pension schemes (including SIPPs) move to strategic platform for all reporting. Firms carrying on investment activities (excluding retail) submit new non-financial data items. Firms who currently submit RMAR/MLAR/Complaints return move to strategic platform for all reporting.

We have also aligned our regulatory reporting requirements to a firm's own **financial year end**. This already applies to firms reporting MLAR, RMAR or Complaints data but will apply to all regulatory reporting when firms start reporting revised data. This will be more efficient for firms as it will enable them to prepare internal management information and regulatory returns at the same time, reducing duplication.

In 2007, we will continue our review of the **Complaints Return** and the first phase of our review of the **RMAR**. We will consider whether the data we receive is appropriate and whether the guidance and training we provide to firms could be improved. We will consult on any changes to these returns in Q3 2007 and publish a Policy Statement in Q4 2007. In 2008 we will review the **MLAR**, and begin the second phase of our RMAR review. Any proposed changes to regulatory reporting requirements arising from these reviews will be subject to consultation in 2008/09.

We will continue to liaise with the industry through the IRR advisory group (comprising mainly trade associations) and Firm Groups, which we have set up to help us take industry views into account in finalising our reporting arrangements.

Further improvements for firms that submit applications and notifications

We receive high volumes of applications and notifications for our eight core regulatory processes: corporate authorisations; waivers; variations of permission; changes of controller; cancellations; outward passporting notifications; individual approvals; and collective investment scheme applications. We place great importance on delivering **good customer service** to firms by ensuring they receive the right regulatory decision through a fair and efficient process. During 2007/08, we are planning to make further improvements to our systems and processes, including introducing easy-to-use online forms for firms to make applications and notifications for the above transactions. We expect that firms will see noticeable improvements in our service; our decisions will be quicker, with consistency and quality maintained. Firms will also be able to submit changes in static data (eg. address) using new online forms. Having implemented the changes to our systems, processes and forms, we will review the application fee we charge firms and consult on any changes.

Contact Centre Improvements

In 2007/08 we will continue to make changes arising from our **reviews of our Firm and Consumer Contact Centres**, including reviewing whether we can make efficiency gains by merging certain functions. The changes are designed to improve our customer service and, particularly for the Firm Contact Centre, support our move towards more principles-based regulation.

In April 2007 we will publish the results of our research into **customer satisfaction** with the service provided by the Contact Centres. We will use this research to assess our performance, identify areas for improvement and set ourselves targets for the future.

The Firm Contact Centre is one of the key ways for firms, particularly smaller firms, to ask for information on, or explanation of, our requirements and expectations. We will **significantly change the way we respond to queries from firms**, moving away from 'signposting' them to relevant rules and guidance, to engaging with them on their individual issues in an increasingly principles-based regime.

In 2007 we will start making the changes necessary to support this shift. The scale of change is significant, and will affect the design of roles, processes, knowledge systems and training. These changes will be rolled out by April 2008 and will be embedded over a longer period.

The Consumer Contact Centre receives a high volume of queries from consumers, either in relation to a specific product or a firm. Currently, frontline consumer contact and leaflet services are outsourced to an external provider. In 2007/08, these services will be provided under new contractual arrangements so that we continue to respond efficiently and effectively to consumer queries and secure better value for money.

Fees

Together with this Plan we are publishing our **annual fees Consultation Paper**, *Regulatory fees and levies 2007/08*. The paper covers the proposed FSA fees, and levies for the Financial Services Compensation Scheme and the Financial Ombudsman Service, for the next financial year. For FSA fees, we estimate that 55% of fee payers will experience fee increases of **no more than 3%** over the 2006/07 fees. This affects smaller firms in particular.

The figures we are consulting on are subject to movements in population and changes to individual firms' fee tariff data in each fee-block. We will publish the final fees and levies for 2007/08 in April and May 2007.

Our **online Fees Calculator** enables firms to calculate their fees and levies based on historic rates and the rates we are now proposing. This helps firms budget for the year ahead. Firms will also be able to continue paying their fees and levies by instalment through a credit provider.

4 Budget for 2007/08

Introduction

In line with delivering our strategic aims in 2007/08, we will continue with our core ongoing regulatory activities whilst developing the effectiveness of our people to move towards a more principles-based regulatory environment. This coincides with scaling up the delivery of our National Strategy for Financial Capability and our commitment to raising the standards of our IT capability.

To communicate the impact of this on our expenditure, we have split this section into four parts:

a. Ongoing Regulatory Activity;

b. Capital expenditure;

c. Costs of the transition to more principles-based regulation; and

d. Assessing the impact on our funding and how we plan to manage the volatility in the level of our fees.

Cost of our Ongoing Regulatory Activity (ORA)

We have prepared our financial data on an International Financial Reporting Standards (IFRS) basis. The original budget for 2006/07 (£276.1m) was prepared using UK-GAAP, but we have now restated it using IFRS which increased the ORA by £3.3m. It also excludes UK Listing Authority application vetting costs which are now recovered directly through application fees (£5.3m in 2006/07), making the revised total ORA for 2006/07, £274.1m.

Our budget for 2007/08 is £301.7m. This represents the costs of our ORA that will help us achieve our three strategic aims. This is £27.6m (10.1%) higher than the equivalent budget for 2006/07 due to additional investments and non-recurring costs, as explained below.

The budget for 2007/08, as set out in Table 4.1, allows us to invest an additional £7.4m to scale up the delivery of our National Strategy for Financial Capability. It also makes a significant (£11.3m) investment to develop our IT delivery and technical infrastructure capability to bring it up to industry standards. These investments are reflected respectively in the increase in professional fees – projects, and in IT costs shown in Table 4.2 and the reduction in staff costs. The budget also includes £0.3m for new duties relating to the implementation of, and ongoing supervision required under, the Third Money Laundering Directive.

Table 4.1: ORA

	2007/08 £m	2006/07 £m	Change £m	Change %
National Strategy for Financial Capability	17.1	9.7	7.4	76.3
IT delivery and technical infrastructure	26.4	15.1	11.3	74.8
Third Money Laundering Directive	0.3	–	0.3	n/a
Other costs	257.9	249.3	8.6	3.4
Total ORA	301.7	274.1	27.6	10.1

Table 4.2: Expenditure by type

	2007/08 £m	2006/07 £m	Change £m	Change %
Staff costs (inc. travel, training, recruitment and pension scheme deficit reduction contributions)	214.7	218.4	(3.7)	(1.7)
Accommodation, office services and depreciation	42.3	41.3	1.0	2.4
IT costs (including IT delivery outsourcing)	29.1	10.5	18.6	177.1
Professional fees – services	19.0	17.6	1.4	8.0
Professional fees – projects	19.5	10.9	8.6	78.9
Printing, publications and other	3.4	3.8	(0.4)	(10.5)
	328.0	302.5	25.5	8.4
Sundry Income	(26.3)	(28.4)	2.1	7.4
Total ORA	301.7	274.1	27.6	10.1

Efficiency Gains

The employment market in the financial services sector is highly competitive. In response to this market pressure, we will lift our payroll inflation to 4.3% for the forthcoming year, significantly ahead of the general inflation rate which we assume to be around 2.6%. We are planning initiatives to make £3m of efficiency savings to reduce the impact of this payroll increase. For example, by making further improvements to our applications and notifications process and introducing Integrated Regulatory Reporting for all firms in 2007/08.

We currently employ around 2,800 people. Consistent with our transition to more principles-based regulation, we aim to meet our strategic aims with fewer people than we currently employ. We propose to reduce our headcount by around 300, spread over the next three years. By the end of 2007/08 we expect our headcount to reduce to around 2700 reflecting the first stage of this transition.

These reductions include the exit of IT contract staff in our Regulatory Services Business Unit that we had employed to cover the initial move to outsourcing our IT delivery. The £4.6m reduction in contract staff costs contributes to the overall decrease in staff costs of 1.7%.

Expenditure by Business Unit

We set out the planned cost of our ORA for each Business Unit in Table 4.3. The figures reflect central service costs (that is, regular IT costs and overheads) distributed to the relevant Business Units based on the number of staff employed in each unit. For 2007/08, we have also allocated the additional £11.3m up-front investment in our IT delivery and technical infrastructure to the Regulatory Services Business Unit. As this Business Unit is responsible for delivering these changes, this expense has not been spread across the other Business Units like regular IT costs.

The increase in the Retail Markets Business Unit budget is mainly due to the investment in financial capability. The Wholesale and Institutional Markets Business Unit will continue to focus its resources on EU-related work and the significant supervisory themes described in *Section One*, with an increase in budget that is below the general inflation rate. Our Regulatory Services Business Unit, as well as having responsibility for delivering the improvements to our IT delivery and technical infrastructure, will make improvements to our contact centres including developing ways to provide more principles-based regulatory support to our stakeholders. We are also increasing the investment in our internal audit function by £0.3m. This will be funded by efficiency savings within Corporate Services and the Board.

Table 4.3: Expenditure by Business Unit

	2007/08 £m	2006/07 £m	Change £m	Change %
Retail Markets Business Unit	116.2	105.4	10.8	10.2
Wholesale and Institutional Markets Business Unit	72.9	72.3	0.6	0.8
Regulatory Services Business Unit	62.3	50.3	12.0	23.9
Corporate Services and the Board	38.8	38.9	(0.1)	(0.3)
Enforcement	37.8	35.6	2.2	6.2
	328.0	302.5	25.5	8.4
Sundry Income	(26.3)	(28.4)	2.1	7.4
Total ORA	301.7	274.1	27.6	10.1

Enforcement costs

The unpredictable size, timing and complexity of enforcement cases means that it is not economical to retain permanent staff to handle all cases. We plan for the cost of external lawyers and accountants on a best estimate of our requirements based on the volume and nature of cases and tribunal activity we typically experience.

We will continue to offer our early settlement scheme that we introduced in October 2005. This gives firms discounts on their financial penalties if cases are settled early, which may enable some consumers to obtain compensation earlier than would otherwise be the case, saving us and the industry resources. In the longer term, we envisage that the scheme will allow us to reduce our enforcement case costs.

Panels and the Complaints Commissioner

The Panels and Complaints Commissioner are forecasting expenditure (£1.8m) similar to 2006/07 (£1.7m) as they expect to undertake similar levels of activity next year. The budget for the Panels and Complaints Commissioner are included in the Corporate Services and the Board figures in Table 4.3.

Contribution to reducing the deficit on our final salary pension scheme

The net deficit in our final salary scheme at 31 March 2006, as measured on an IAS 19 basis, was £91.3m. For funding purposes however, we apply a different set of actuarial assumptions and valuation method to that required by IAS 19. This more accurately reflects our agreed investment and funding strategy. Using that calculation our funding deficit at 31 March 2006 was closer to £40m.

In our 2006/07 Business Plan we restated our commitment to making additional pensions deficit reductions of £6m over a number of years until that deficit was eliminated, and so paid that contribution early in the year. We also set out our policy of pro-actively considering other reasonable options that may help to meet our obligation to provide scheme members' benefits, but without introducing significant risk or volatility in the level of our fees. So, in 2006/07 we used a new credit facility (explained below) to finance an additional £20m deficit reduction contribution to our final salary pension scheme. This allows us both to reduce our funding deficit and to improve the matching of our surplus assets against our liabilities.

To spread the impact of such a large sum, we will recover this cost at approximately £2.5m a year within our ORA. Because this additional contribution has reduced our funding deficit, we estimate that the level of additional pension deficit reduction we need to make to meet our commitment will be lower. So we plan to reduce the level of our additional deficit reduction contributions in 2007/08 from £6.0m to £2.5m. This will be offset by reduced interest income on lower cash balances.

Capital expenditure

In addition to the cost of our ORA and transition expenses, we will incur £49.5m of capital expenditure on projects that will last a number of years, compared to £14.7m in 2006/07. This is an increase of 236.7% (see table 4.4). Capital expenditure is our cash expenditure on fixed assets funded out of positive cashflow and borrowings. This expenditure is recovered through our ORA (via the depreciation charge) as the assets are used over their lifetime.

This increase is due to the investment in our IT development (applications and software), in particular Sabre 2, replacing assets required to bring our IT systems up to industry standards and developing the knowledge management tool. We will also make improvements to our offices in 25TNC in addition to increased capital works required as part of our lease.

Table 4.4: Capital expenditure

	2007/08 £m	2006/07 £m	Change £m	Change %
IT development (IRR, Sabre 2, Knowledge management)	24.0	12.5	11.5	92.0
IT infrastructure	6.7	1.1	5.6	509.1
Leasehold improvements	18.8	1.1	17.7	1609.1
Total capital expenditure	49.5	14.7	34.8	236.7

Table 4.5: AFR

	2007/08 £m	2006/07 £m	Change £m	Change %
Budget for ORA	301.7	274.1	27.6	10.1
Funding the transition to more principles-based regulation	5.0	12.2	(7.2)	(59.0)
Smoothing IT investment	(6.6)	–	(6.6)	N/A
Reserves release	–	(12.2)	12.2	100.0
AFR	300.1	274.1	26.0	9.5

Additional costs of the transition to more principles-based regulation

We will set aside £50m to improve the effectiveness of our people and move towards a more principles-based regulatory approach. This will cover non-recurring transition expenses such as staff re-organisation costs, training and development and improving our Knowledge Management. To avoid passing this cost on to fee-payers in a single year, we have arranged to borrow funds to finance these costs and will spread the cost over up to ten years. We have included £5m in the 2007/08 Annual Funding Requirement (AFR) to cover this expenditure.

Funding the FSA in 2007/08

New credit facility

To finance the costs of delivering more principles-based regulation, overhauling our IT delivery and technical infrastructure and funding our commitments for our final salary pension scheme, we have taken a new £100m revolving credit facility contract with Lloyds TSB Bank plc.

Given that the costs of these initiatives relate to benefits we expect to see, or resources we will use in future years, it is more appropriate to charge these costs to fee-payers over that longer period, rather than in the year the expenditure is incurred. This allows us to improve the way we manage the volatility in our fees, and the matching of our assets and liabilities.

Depending on the timing of our fee collection cycle, there will be periods of the year when the new borrowing facility will be used to fund such expenditure and other times when we have surplus funds available for investment. So, our revolving credit facility will run alongside and operate within an integrated agency treasury service, allowing us to manage our net financing costs. We will repay borrowings and financing costs under this facility using funds we raised as part of the AFR, over the periods in which we expect the corresponding benefits will be realised.

With this revolving credit facility in place, we no longer need to maintain reserves at the previously targeted level of 3% to 7% of the costs of our ORA. In future, we plan to reduce our reserves from this target to -2% to 2%. If unforeseen events happen, we anticipate we will have the financial capacity within the revolving credit facility to meet any extra costs.

We will use the surplus reserves available at 31 March 2007 to fund the first stage of the transition expenses we referred to earlier. This means the reserves movement will not affect our AFR for 2007/08. This is in addition to the £5m transitional expenditure included in the 2007/08 AFR which will bring the total transitional funding at this stage to around £17m.

Annual Funding Requirement (AFR)

The AFR is the amount of money that we need to raise from fees. The total amount required to fund our budgeted costs and to allow us to make an appropriate repayment of our borrowings (both in respect of our transition expenses and the £20m additional pension deficit contribution we made in 2006/07) is £300.1m as set out in Table 4.5.

The AFR increases by 9.5% on 2006/07. As we explained, the increase is mainly because of the increase in our financial capability and IT budgets. But, consistent with our intention of managing the volatility in the level of our fees, we are smoothing the impact of our IT investment over a five-year period.

The 2007/08 Fees Consultation Paper, published alongside the Business Plan, explains how we propose to raise the AFR from fee-payers and provides an opportunity for comment on our fee proposals.

Financial management and reporting framework

The scope of activities falling within the FSA's 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:

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

Our Board believes 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

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

Changes in scope (increase or decrease)

Sometimes the Treasury legislates to change the scope of activities that we regulate. Any scope changes, as with our other core operating activities, are subject to financial management as part of our budget process. However, in the first financial year affected by the change in scope, and until the 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 an integrated part of our ORA.

Exceptional items

We have included these costs in the ORA and we will report on material movements each year.

External enforcement costs

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

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 the budgeted level and may try 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. We have included these costs within our ORA.

Complaints Commissioner

FSMA requires us to have arrangements in place to investigate complaints against us. The Complaints Scheme was introduced on 3 September 2001 to do this. FSMA requires us to ensure that the Complaints Commissioner can conduct a full investigation into any complaints. The Complaints Commissioner controls his own costs against his budget, which is subject to our approval, and is funded through our fees. These costs are included within our ORA.

Pension scheme deficit reduction

The amounts required to reduce this deficit over time are inherently variable, and they depend on several variable factors including current investment values and projected investment returns. We intend to eliminate this deficit over a ten-year period.

Transition costs

The changes necessary to improve the effectiveness of our people and move towards a more principles-based 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 are required to maintain the equivalent value of six weeks of our ORA as a contingency fund. We previously targeted our reserve levels at 3% to 7% of the costs of our ORA. We now anticipate that we will have sufficient financial capacity within the revolving credit facility to meet any expenditure required to address unforeseen events. So, in future, we plan to reduce our reserves from this target to -2% to 2%.

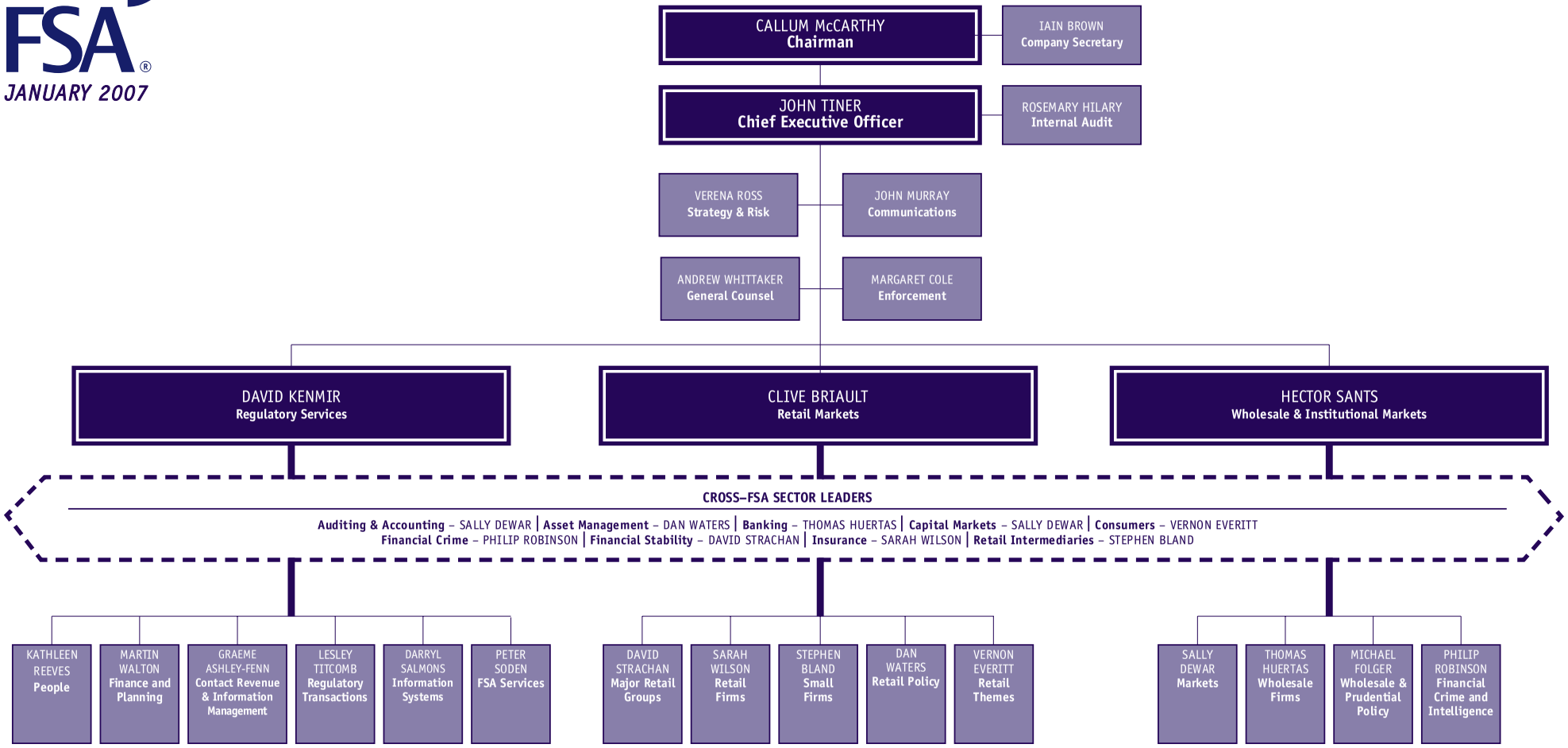
Appendices

Appendix One:
The Board of the Financial Services Authority at 25 January 2007

Sir Callum McCarthy	Chairman, the FSA
Dame Deirdre Hutton CBE	Deputy Chairman, the FSA Chair, Food Standards Agency Vice Chair, the European Food Safety Authority
John Tiner	Chief Executive, the FSA
Clive Briault	Managing Director, Retail Markets, the FSA
Sir James Crosby	Non-executive Director, ITV plc Chair, the Public Private Forum on Identity Management
Peter Fisher	Managing Director, BlackRock Inc Chairman, BlackRock Asia
Brian Flanagan	Non-executive Director, William Morrison Supermarkets plc
Karin Forseke	Formerly Chief Executive, D. Carnegie & Co AB
Sir John Gieve	Deputy Governor (Financial Stability), Bank of England
David Kenmir	Managing Director, Regulatory Services, the FSA
Professor David Miles	Managing Director and Chief UK Economist, Morgan Stanley, London Visiting Professor of Financial Economics, Imperial College, University of London
Hector Sants	Managing Director, Wholesale and Institutional Markets, the FSA
Michael Slack	Chairman, The Fyfe Group Ltd Director, British Insurance Brokers Association
Hugh Stevenson	Chairman, Equitas Limited Chairman, The Merchants Trust plc Non-executive director, Standard Life plc

Appendix Two

FSA®
JANUARY 2007



Appendix Three: Milestones for 2007/08

This chart includes all currently planned major publications.
Not all of the milestones are referred to in the text of the Plan.

PROMOTING EFFICIENT, ORDERLY AND FAIR MARKETS

	2007 Q1: January-March	2007 Q2: April-June	2007 Q3: July-September	2007 Q4: October-December	2008 Q1: January-March
Markets in Financial Instruments Directive (MiFID)	Policy Statement			Implementation	
Non-MiFID conduct of business: deferred matters		Consultation Paper		Policy Statement	
Wider reform of COB rules (NEWCOB)		NEWCOB Policy Statement		Implementation of NEWCOB	
Permissions and notifications	Guide for firms				
Transaction reporting			Users Pack		
Organisational systems and controls					
Applying organisational systems & controls to common platform (MiFID/CRD) firms	Implementation				
Extending the common platform to non-MiFID firms				Consultation Paper	
Capital Requirements Directive	Implementation in the EU of revised Basel framework				Implementation
Treatment of banks' investment in insurers				Consultation Paper	
Own funds/definition of capital				Discussion Paper	
Review of the regulatory framework in the commodity derivatives sector				Discussion Paper	
Transparency Directive	Implementation				
International Financial Reporting Standards				Consultation Paper	

PROMOTING EFFICIENT, ORDERLY AND FAIR MARKETS continued

	2007 Q1: January-March	2007 Q2: April-June	2007 Q3: July-September	2007 Q4: October-December	2008 Q1: January-March
Contracts for difference			Publish findings		
Solo/Group capital requirements	Begin review		Publish findings		
Single and dual pricing of collective investment schemes	Implementation				
Insurance					
Commission disclosure – wholesale insurance contracts	Begin review			Publish findings	
Client money review	Publish findings				
Capital markets and financial exchanges					
Private Equity		Feedback Statement			
Investment exchanges and clearing houses		Consultation Paper		Feedback Statement	
Listing rules for investment entities		Policy Statement	Implementation		
Listing rules – general update		Policy Statement			
Commodities markets	Occasional Paper				
Use of auditors as a supervisory tool			Consultation Paper		
Financial Stability					
Market-Wide Exercise	Workshops				
Resilience Benchmarking			Repeat survey	Publish findings	
Financial Crime					
Survey	Survey results				
Third Money Laundering Directive				Implementation	

HELPING RETAIL CONSUMERS ACHIEVE A FAIR DEAL

	2007 Q1: January-March	2007 Q2: April-June	2007 Q3: July-September	2007 Q4: October-December	2008 Q1: January-March
Retail Distribution Review		Discussion Paper			
Wrap platforms		Discussion Paper			
Capable and confident consumers					
Learning Money Matters school programme				Targets achieved	
Money Doctors toolkit				Targets achieved	
Training for youth workers				Targets achieved	
Make the Most of Your Money				Targets achieved	
Clear, simple and understandable information					
Advertising Campaigns	Insurance		Promoting *MoneyMadeClear* website		
New versions of hard-copy publications		Begin roll-out			
Point-of-sale product disclosure: 'key facts' documents			Publish examples of good and poor practice		
Treating customers fairly					
Provider and distributor responsibilities statement		Publish statement			
TCF implemented in firms	Deadline	Publish findings			
Corporate culture			Publish examples of good and poor practice		
Progress towards consumer outcomes				Progress report	

HELPING RETAIL CONSUMERS ACHIEVE A FAIR DEAL continued

	2007 Q1: January-March	2007 Q2: April-June	2007 Q3: July-September	2007 Q4: October-December	2008 Q1: January-March
Meeting the needs of older consumers				Publish findings	
Climate change				Begin review	
Capital requirements for Personal Investment Firms					Consultation Paper
Conduct of business (COB)					
MiFID COB requirements	Policy Statement				
Wider reform of COB rules (NEWCOB)		NEWCOB Policy Statement		Implementation of NEWCOB	
Mortgages					
Affordability		Publish findings			
Home reversions and home purchase plans		Implementation			
Effectiveness review: stage two		Begin review			Publish findings
Financial Advice					
Depolarisation				Consultation Paper	
Benefits of Menu and rules on suitability		Publish findings			
Basic Advice Regime		Announce terms of reference and begin review			

HELPING RETAIL CONSUMERS ACHIEVE A FAIR DEAL continued

	2007 Q1: January-March	2007 Q2: April-June	2007 Q3: July-September	2007 Q4: October-December	2008 Q1: January-March
Insurance					
Review of general insurance conduct of business rules	Publish report	Consultation		Policy Statement	
Findings from PPI thematic review (third stage)			Publish findings		
Review of intra-group investment management services	Pilot review				
Asset management					
Funds of unregulated collective investment schemes and permitted links	Consultation Paper				
Pensions					
Self-invested personal pension (SIPPs)		Implementation			
State second pension (S2P)		Publish findings			
Financial Services Compensation Scheme (FSCS) funding review	Consultation Paper			Policy Statement	
Other Handbook reviews					
Client Assets sourcebook			Begin review		Consultation Paper
Approved Persons Regime	Policy Statements			Implementation	
Training and Competence sourcebook	Consultation Paper		Policy Statement	Implementation	
Enforcement and decision-making manuals	Consultation Paper	Policy Statement			
Review of close links regime				Consultation Paper	

IMPROVING OUR BUSINESS CAPABILITY AND EFFECTIVENESS

	2007 Q1: January-March	2007 Q2: April-June	2007 Q3: July-September	2007 Q4: October-December	2008 Q1: January-March
A more principles-based approach to regulation		Publish report/ hold conference	Roll-out of staff training		
People					
Graduate programme			Summer Internship Programme	2007 Graduate Intake	
				2008 Graduate Recruitment	
Technical Infrastructure					
IT support and maintenance	Outsourced				
Transformation of IT operation			Achievement of Industry Standard		
Regulatory reporting by CRD firms	Implementation				Implementation
Regulatory reporting by MiFID firms	Policy Statement				Implementation
RMAR/Complaints Return reviews			Consultation Paper	Policy Statement	
Contact Centre Improvements					
Customer satisfaction research		Publish results			
Fees and Costs	Consultation Paper				

PUB REF: 000642

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.