Financial Services Authority

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Internal Audit report

A review of the extent of awareness within the FSA of inappropriate LIBOR submissions

Management Response

March 2013

FSA Internal Audit review of LIBOR

Management Response

The FSA executive team, including Martin Wheatley as CEO designate of the FCA and Andrew Bailey as CEO designate of the PRA, accept the findings of the Internal Audit Report on LIBOR and will take its recommendations forward into the FCA and PRA. The Report is important: it reveals ways in which the FSA response to information on LIBOR market dislocation was too narrowly focused; but it also suggests a question relating to the limits of feasible supervisory oversight; and points to the potential benefits of separating prudential and conduct regulation.

The Internal Audit Report on LIBOR is the third public report in which the FSA has evaluated its effectiveness in the period up to and including the financial crisis, following the Internal Audit Report into the failure of Northern Rock (March 2008) and the Board Report into the failure of RBS (December 2011). The reports into Northern Rock and RBS identified clear examples of major regulatory failure - both in the international capital framework and in the FSA's own approach to supervision - and made recommendations that helped transform the performance of the FSA. The Internal Audit report on LIBOR identifies important areas where the FSA should have performed better, and makes valuable recommendations for the future, but does not suggest major regulatory failure on the scale identified in the Northern Rock or RBS reports.

This Management Response sets out:

1) The background to the Internal Audit Report into LIBOR ("the Report");
2) The summary conclusions of the Report and the Management Response;
3) FSA observations on trader manipulation; and
4) The actions to be taken forward by the FCA and PRA

1. Background

Enforcement action

1.1. The FSA, CFTC and DoJ have taken enforcement action against Barclays, RBS and UBS[1] for failures in respect of LIBOR submissions. A number of other regulatory investigations are ongoing and criminal authorities, including the Serious Fraud Office, are pursuing investigations. The action taken against firms in relation to LIBOR has addressed two distinct forms of behaviour:

a) Lowballing for reputational reasons ('lowballing') – some firms, during the financial crisis, reduced some of their LIBOR submissions in an apparent attempt to avoid negative market and media comment on their cost of borrowing; and

b) Attempts to manipulate submissions to influence the ultimate LIBOR fix of rates ('trader manipulation') – traders whose bonuses were influenced by profits in part driven by deals linked to LIBOR, had an interest in pushing LIBOR up or down depending on the deal. Webs of traders within and in some cases across banks and other firms systematically attempted to manipulate LIBOR to benefit themselves and one another.

The Wheatley Review

1.2. Following the publication of the enforcement action against Barclays in June 2012, the Chancellor of the Exchequer asked Martin Wheatley, CEO designate of the FCA, to consider whether the revelations surrounding LIBOR required a wider policy response. The Wheatley Review, published in September 2012, made clear that the process for setting and policing LIBOR was fundamentally flawed. The system had in-built conflicts of interest which were inadequately controlled by both the contributing banks and the British Bankers' Association ("BBA"), the body responsible for overseeing the LIBOR fixing process. The system also lacked external accountability:

"At present neither submitting to LIBOR, nor administering LIBOR, is a regulated activity under FSMA. As a result, while the FSA is currently taking regulatory action in relation to attempted manipulation of LIBOR by firms, this action is proceeding on the basis of the connection between LIBOR submitting and other regulated activities, and there is no directly applicable specific regulatory regime covering these activities. This affects the FSA's ability to supervise and take enforcement action in relation to these activities, even when carried out by a firm that is regulated in respect of its general business activities"[2]

[1] The Japanese FSA and FINMA have also taken action in relation to UBS.
[2] The Wheatley Review of LIBOR: final report, September 2012, p.11

1.3. The Wheatley Review made ten recommendations for the reform of LIBOR, three of which related to the regulation and administration of LIBOR:

- The acts of submitting to and administering LIBOR should be designated as regulated activities in order to significantly enhance the FSA's ability to oversee these processes and take action in relation to any misconduct. Submitting and administering LIBOR should become controlled functions, in order to allow the FSA to ensure the accountability of key individuals.

- Responsibility for LIBOR administration should be transferred from the BBA to a new administrator, who will be responsible for compiling and distributing the rate, as well as providing credible internal governance and oversight.

- The new administrator should fulfil specific obligations as part of its governance and oversight of the LIBOR rate, having due regard to transparency and fair and non-discriminatory access to the benchmark. These obligations will include surveillance and scrutiny of submissions, publication of a statistical digest of rate submissions, and periodic reviews addressing the issue of whether LIBOR continues to meet market needs effectively and credibly.[3]

1.4. The Government accepted all ten recommendations in the Wheatley Review in October 2012, including those relating to regulation as set out above. From 1 April 2013, the Government will make both submitting to LIBOR, and administering LIBOR, regulated activities. The Government have also established a panel, led by Baroness Hogg, to appoint a successor to the BBA as LIBOR administrator.

[3] Wheatley Review, p8.

The Internal Audit Report

1.5. The UK authorities were acutely aware that there was significant 'dislocation' in the LIBOR market in 2007-08. This 'dislocation', which occurred when market conditions deteriorated significantly from the second half of 2007, manifested itself in five main ways:

- the spread between LIBOR fixings and other rates (such as the Overnight Indexed Swap rate) widening;
- the volatility in LIBOR fixings and spreads;
- the divergence between LIBOR submissions and actual rates that could be obtained in the market;
- a wider dispersion of LIBOR submissions;
- a greater divergence between funding rates for different banks on their perceived creditworthiness (tiering).

Clear evidence of this dislocation did not in itself, however, carry any implication that 'lowballing' was occurring.

1.6. However, after the publication of the Barclays Final Notice in June 2012, Barclays provided the Treasury Committee with evidence of 13 communications with the authorities (Bank of England and FSA) which Barclays believed suggested that the authorities ought to have been aware of rumours of 'lowballing'. The FSA Chairman therefore asked Internal Audit to set out the facts of what the FSA knew and to form a judgement about the appropriateness of the FSA's responses at the time.

1.7. The Enforcement investigations found evidence of 'lowballing' concentrated in the period of extreme market stress which lasted from summer 2007 to early 2009. Internal Audit therefore focused on the time period January 2007 to May 2009, to ensure full coverage of the periods in which lowballing was most likely to have occurred. Internal Audit also reviewed the evidence for any references to the possibility of 'trader manipulation' in this period. Whilst our Enforcement investigations identified that attempted 'trader manipulation' occurred between 2005 and 2010, the 2 ½ year period covered by Internal Audit provides a reasonable sample by which to judge whether information flows referring to 'trader manipulation' were available to the FSA.

1.8. Internal Audit searched 17 million records to identify any reference to the letters IBOR. [4] It reviewed in detail the 97,000 records where the letters IBOR were found, and it interviewed 20 FSA employees or ex-employees. The report cost approximately of £600,000, primarily in internal staff costs and data costs.

[4] This search criterion thus captured references to EURIBOR as well as to LIBOR

2. Conclusions of the Report and summary management response

The Report

2.1. Unsurprisingly, given the severe market stresses and their potential implications for financial stability, the Report identifies extensive awareness of LIBOR 'dislocation' in the 2007-08 period across all levels of FSA management. This does not, in itself, suggest either that there was any awareness of 'lowballing' or that FSA staff should have inferred that 'lowballing' was occurring.

2.2. However, the Report also identifies a number of instances where the information received could have suggested that lowballing may have been occurring. The Report does not identify any instances of the FSA, at any level, being aware of attempted 'trader manipulation'.

2.3. The Report makes the following conclusions in respect of information received by the FSA:

- The Report identified many communications that indicated LIBOR 'dislocation', particularly between April and June 2008. Throughout the review period, the FSA's focus was on the impact of the deteriorating market conditions for individual firms' capital and liquidity positions and in some cases their very viability. The FSA recognised that LIBOR dislocation was caused, at least in part, by structural issues in the LIBOR fixing process interacting with the deteriorating market conditions. It therefore fed into the BBA's review of that process.

- Of the 97,000 documents and emails reviewed, Internal Audit highlighted 74 which they considered relevant to the issue of whether lowballing might be possible or might have occurred. Internal Audit judged 26 of the 74 communications to include a direct reference to potential or actual lowballing, of which the significant majority (17) were received between April and June 2008. These 26 communications included the telephone calls from Barclays in March and April 2008, which have been in the public domain since the publication of the Enforcement Final Notice in June 2012. The Report concluded that these two communications were the clearest contacts that indicated an individual bank was lowballing. In relation to the communications that did not have a direct reference to lowballing (i.e. the remaining 48 communications), the Report concluded that they might have provided an indication of the possibility of 'lowballing' (or at least of circumstances which created the incentive for 'lowballing') particularly when considered in aggregate.

- The Report also identified some material that argued that LIBOR findings were not being manipulated - for example, the conclusions of an article within the Bank for International Settlements Quarterly Review (March 2008) and the International Monetary Fund's Global Financial Stability Report (October 2009).

<u>Management Response</u>

2.4. The appropriate management response to the findings of the Report needs to reflect two important elements of context:

1) During the financial crisis, the senior management of the FSA prioritised the prudential regulation of systemic firms, and the question of wider financial stability, above all other issues. The current management of the FSA, including the CEOs designate of the FCA and PRA, believe this to have been an appropriate response for an integrated prudential and conduct regulator at the time.

2) The large volume of documents referring to LIBOR during the review period (97,000) contained only a small number (74) that could have been interpreted as providing information relevant to the 'lowballing' issue and a still smaller number (26) which directly referred to 'lowballing'. This information was often made in the context of other subjects, e.g. general market updates or liquidity information received from firms. This illustrates the difficulty, exacerbated during a financial crisis, of FSA staff taking a broad, questioning approach to every piece of information they receive.

2.5. Notwithstanding this context, we accept the Report's overall conclusion that the FSA's focus on dealing with the implications of the financial crisis, together with the fact that contributing to or administering LIBOR were not 'regulated activities', led to the FSA being too narrowly focused in its handling of LIBOR related information. In section 4 below, we respond to the Report's more specific conclusions and address the recommendations made for the FCA and PRA.

3. Trader Manipulation

3.1. The CFTC and FSA began enquiries into potential lowballing of LIBOR in 2008 and, as part of these enquiries, required firms to conduct a comprehensive analysis of emails and other communications relating to the LIBOR submitting process. As a result of this analysis, and thus as a by-product of the 'lowballing' enquiries, evidence of 'trader manipulation' emerged. Before this point, the senior management of the FSA had not been aware that traders were attempting to manipulate LIBOR for personal gain. To the best of our knowledge, neither the senior management of panel banks, the BBA nor the CFTC had been aware of attempted 'trader manipulation' prior to this point, nor had the possibility of 'trader manipulation' been reported in the media.

3.2. The Report covered the period January 2007 to May 2009 and was primarily focused on 'lowballing'. It also, however, reviewed the evidence for any suggestion that the FSA, at any level, was aware, or should have been aware, of attempted 'trader manipulation'. Internal Audit found no evidence to suggest that there were any communications, pieces of information or market rumours which might have alerted FSA staff to this issue. We know from the Enforcement investigations that some traders were discussing manipulating submissions on trading floors, on email and on internal chatrooms, but the FSA was not party to this information. The BBA did not raise concerns over the conduct of market participants with the FSA. The issue of the FSA's appropriate interpretation or response to information received does not therefore arise in relation to 'trader manipulation'.

3.3. There remains the wider question as to whether the FSA could have adopted a supervisory approach that would have identified the issue earlier. But it is not clear that such an approach would have been feasible; identifying attempted such activities in real time would have required a very large and perhaps disproportionate amount of resource (e.g. FSA supervisors sitting real time in multiple dealing rooms). This may illustrate that regulators cannot spot all potential problems in advance, but have to rely on:

- firms policing themselves on a day to day basis;
- with effective processes for the supervisory review of firm's systems and controls;
- supported by whistleblowing and other procedures to bring problems to light; and
- punished by exemplary post facto penalties when offences do occur.

In general, this is the basis of most supervisory approaches, not just in the UK but globally.

3.4. A more intensive approach, which does entail real-time market monitoring, is taken by the FSA in respect of market abuse and insider dealing for instruments within the scope of the market abuse regime. Market operators (e.g. stock exchanges and brokers) are required to install appropriate systems and controls to monitor trades and to submit Suspicious Transaction Reports to the FSA when suspicious activity is identified. In addition the FSA deploys sophisticated market surveillance software to directly monitor markets and has over 10 billion transaction reports in its database. The FSA investigates suspicious transactions and has a strong track record of bringing civil and criminal enforcement action which acts as a deterrent to potential wrongdoers.

3.5. LIBOR did not fall within the scope of the market abuse regime, and therefore the FSA had neither the justification nor the mandate to adopt a similarly sophisticated and costly approach to monitoring or enforcement. Under the new regulatory regime being implemented in response to the Wheatley Review, the LIBOR administrator will be required to undertake monitoring of submissions, and the FCA will be able to prosecute a new criminal offence of making false or misleading statements in relation to LIBOR.

4. Actions for FCA and PRA

Lesson 1	The regulatory perimeter
Audit Conclusions	• The FSA should have given explicit consideration to the FSA's responsibilities for regulated firms' conduct in relation to the Principles for Businesses and the potential for (and impact of) lowballing, rather than being focused solely on the BBA's oversight role for the LIBOR fixing process, particularly in the period after the BBA started its review.
Audit Recommendations	• Audit questioned whether there might be other significant non-regulated activities, where wrongdoing by regulated firms in relation to those activities could breach the FCA and PRA Principles for Businesses, pose a threat to the safety and soundness of those firms, or potentially cause significant consumer or market detriment. • Audit recommended that FCA and PRA senior management consider how such activities will be identified and assessed by the new regulatory authorities risk and governance frameworks, so that risk-based prioritisation decisions can be made in relation to them.
Management Response	As the Report makes clear, one reason why FSA staff took a narrow focus when handling LIBOR related information was that submitting to, or administrating, LIBOR were not regulated activities. We agree with Audit's observation that wrongdoing by regulated firms in respect of non-regulated activities can impact on our statutory objectives. We also recognise the importance of the FCA and PRA having appropriate mechanisms for identifying risk and assessing such activities, and of taking action where those activities threaten their statutory objectives. However, it is necessary to recognise that regulators operate within a limited budget, and that when allocating policy, supervisory and enforcement resources, choices must be made as to where regulators believe they can have most impact on reducing risk to their statutory objectives as specified by Parliament. It should also be noted that legislative or jurisdictional issues can limit the actions that regulators may take in respect of non regulated activities.

Lesson 1	The regulatory perimeter
Management Response (cont)	LIBOR In relation to LIBOR specifically, the Internal Audit report recognises that the FSA's approach of feeding into the BBA's 2008 LIBOR review was appropriate but notes, with the benefit of hindsight, that there was an opportunity for the FSA to have pressed the BBA for a more radical outcome in their 2008 review. However, the FSA did not identify LIBOR dislocation as being a direct risk to its objectives during this period. The FSA also believed that issues over LIBOR dislocation had largely been resolved by the time the BBA review was published in December 2008. The Internal Audit report covers the 2007-09 period, but it is worth noting that as the seriousness of LIBOR lowballing and trader manipulation became apparent, as a result of enforcement investigations, we took a more proactive role in challenging the LIBOR framework. Alongside our enforcement work, we undertook a supervisory review into LIBOR submissions in early 2011, supported by Ernst and Young, which identified a large number of anomalous submissions. Following this review, we took supervisory action, requiring all panel firms to provide us with an attestation that they had appropriate systems and controls in place for LIBOR. We also made recommendations to Tripartite Deputies on LIBOR reform in October 2011. The Regulatory Perimeter - FCA The FCA will primarily be a conduct regulator, with a broad remit covering a wide range of firms, from global financial groups to sole traders, and an equally wide range of financial services and products. To deliver this broad remit, the FCA will use a strategic risk framework to compare and quantify risks within and across a wide variety of products and sectors, and to make risk based decisions on how best to deploy regulatory tools to minimise risks to statutory objectives. The strategic risk framework will recognise that non-regulated activities, which could be well established activities that do not fall within the definitions of the Financial Services Act 2012 (e.g. the creation of coal or gas benchmarks) or new activities or products that may develop in future, have the potential to impact on the FCA's strategic or operational objectives. In November 2012, we agreed that the FCA should build a regulatory perimeter workstream within the new Policy Risk and Research Division, and in January 2013 agreed that the FCA should adopt 13 principles for assessing perimeter risk, including: • Perimeter risks will be an integral part of the risk management process; • The FCA will proactively look beyond the regulatory boundary to identify potential issues;

Lesson 1	The regulatory perimeter
Management Response (cont)	• Issues which fall outside the FCA's routine regulatory scrutiny will be considered a perimeter risk if they pose a risk to statutory functions, though it may transpire that the FCA does not have the regulatory powers to act; • As perimeter risks will be non-core to the FCA's regulatory work, but have the potential to be highly significant, they will be investigated to the point where a decision on appropriate response (which may be to do nothing) can be made; • The FCA's risk appetite for perimeter issues will be higher than for our regulated activities, but once the threshold has been reached, the FCA will use the toolkit of all possible actions; and • The FCA will cooperate and coordinate activities with other bodies and pass on information where appropriate and permissible. The FCA's new perimeter workstream will operate in a pilot mode from 1 April 2013 and we expect it to be fully operational by the end of 2013. The FCA will also act in accordance with IOSCO principles, including Principle 7, which requires all securities regulators to have formal processes in place for reviewing the perimeter of regulation. <u>The regulatory perimeter - PRA</u> The PRA will be a prudential regulator responsible for the most systemically important firms, and will adopt a supervisory led approach to regulation. When supervisors apply the PRA's high level standards for systems and controls, or set capital and liquidity requirements for individual firms, they will consider all activities that have the potential to impact on a firm's safety and soundness. Supervisors will therefore have a direct mandate for considering all aspects of a firm's prudential position, regardless of whether those risks emerge from regulated or unregulated activities. That said, the PRA's approacdh will be to focus on those issues that pose the greatest risk to its statutory objectives. The PRA will co-operate closely with the Bank of England and the FPC to develop wider market intelligence and ensure that emerging risks, or risks relating to non-regulated activities, form part of the ongoing supervisory approach.

Lesson 2	Roles and Responsibilities
Audit Conclusions	• The FSA should have: clarified roles and responsibilities within the FSA, including for dealing with external bodies; sought clarification of the roles and responsibilities of external bodies; and sought clarification of the roles and responsibilities between Tripartite authorities – particularly give the relevant communications being circulated by the Bank of England. • The FSA should have ensured that communications were analysed circulated and escalated in an appropriately targeted manner. This would have helped make it clearer what action might be required and by whom, and identify linkages between communications so they could be considered in aggregate. This was particularly the case for information received by supervisors, especially in relation to Barclays (though Audit recognised the supervisory team's competing priorities and resource constraints).
Audit Recommendations	• The FCA should satisfy itself that there is a clear division of responsibilities relating to LIBOR between the authorities in the new regulatory framework, including for receiving and sharing LIBOR-related information and for acting on that information where necessary. If FCA senior management finds that the division of responsibilities is not clear, it should act with the PRA senior management and other regulatory authorities to seek clarification. • FCA senior management should establish clear internal roles and responsibilities relating to LIBOR
Management Response	The Government accepted the recommendations of the Wheatley Review in full and introduced legislation, in the Financial Services Act, to bring LIBOR within the scope of statutory regulation from 1 April 2013. We recognise the importance of establishing clear responsibilities for the integrity of LIBOR and have set out clear expectations of the FCA, the LIBOR administrator, panel banks and individuals involved in the LIBOR process. We are currently finalising the rules for the new regulatory regime, which will be led by the FCA's Markets Division. To review the effectiveness of the new regime, the FCA will conduct a thematic review of LIBOR panel banks' compliance with the new regime within a year of it coming into force.

Lesson 2	Roles and Responsibilities
Management Response (cont)	<u>FCA</u> The FCA will be responsible for the supervision of the LIBOR administrator and will consider LIBOR systems and controls when supervising panel banks. The FCA will also monitor LIBOR for evidence of malpractice and market abuse. If malpractice is identified, the FCA has a new mandate to investigate and prosecute a new criminal offence of making false or misleading statements, or creating false or misleading impressions in relation to specified benchmarks (such as LIBOR). <u>The LIBOR administrator</u> The LIBOR administrator will be required to draft and publish a code of conduct to provide guidelines for submissions and manage conflicts of interest. It is envisaged that the FCA will endorse this code as industry guidance. The administrator will also have a clear role in the monitoring of submissions, with an oversight committee being responsible for ensuring scrutiny of suspicious submissions and reviewing the composition of LIBOR panels. A committee, led by Baroness Hogg and containing representatives from the Bank of England, FCA and HMT, are currently running a tendering process to appoint a successor to the BBA as LIBOR administrator. <u>Panel Banks</u> Panel banks will be required to establish and maintain effective organisational arrangements for making submissions (including oversight by senior personnel and compliance, and periodic internal audit reviews), establish an effective methodology to determine daily submissions supported by relevant transactions, manage conflicts of interest and keep adequate records. These systems and controls will be subject to regular and periodic external audits and FCA supervisory oversight. The FCA will also expect the panel banks to follow the code of conduct, which the FCA intends to endorse as industry guidance.

Lesson 2	Roles and Responsibilities
Management Response (cont)	Individuals The administrator will be required to appoint specific persons as being responsible for the oversight of the administrator's compliance with its obligations under the new regulatory regime for LIBOR administration. These persons will require FCA approval and will be required to comply with the FCA Principles for Approved Persons. Panel banks will be required to appoint a specific person with responsibility for overseeing the bank's compliance with its obligations as a submitter under the new regulatory regime. This person will require FCA approval and will be required to comply with the FCA Principles for Approved Persons. PRA Both the PRA and other areas of the Bank of England will receive intelligence in relation to LIBOR, in particular in liquidity reports submitted by firms to the PRA and from the Bank of England's Sterling Money Markets Division, and will pass relevant information to the FCA. The FCA will establish clear protocols for receiving and managing this information, within the framework of the wider Memorandum of Understanding between the FCA and PRA.

Lesson 3	Culture of the Regulatory authorities
Audit Conclusions	• The FSA should have considered the possibility and likelihood of lowballing (particularly in the period from April 2008) rather than assuming the only problem was the interaction between deteriorating market conditions and structural issues in the LIBOR fixing process. • The FSA should have been more inquiring and challenging of the information in individual communications and more sensitive to the accumulation of communications it received.
Audit Recommendations	• The FCA and PRA senior management should embed the lessons from this review appropriately in the cultures of the regulatory authorities. This should include ensuring that staff are sufficiently inquiring and challenging and that they maintain the necessary breadth of perspective.
Management Response	As the Internal Audit report makes clear, one reason why FSA staff took a narrow focus to handling LIBOR related information was the intense focus on prudential issues during the financial crisis. The FSA was aware of dislocation of LIBOR market in 2007 and 2008, but the focus of both junior staff receiving the communications, and senior staff taking risk based prioritisation decisions on how to deploy FSA resource, was on the wider causes of the dislocation, the implication for financial stability and the safety and soundness of regulated institutions. Given the unprecedented financial stability issues at the time, we believe that this was an appropriate response for an integrated prudential and conduct regulator.

Lesson 3	Culture of the Regulatory authorities
Management Response (cont)	From 1 April 2013, each organisation will have a single overarching objective: the PRA is required to *promote the safety and soundness of PRA authorised persons*, whilst the FCA is required to *ensure that the relevant markets function well*.[5] This separation will allow each authority to focus attention on their specific mandate, and will create two distinct groups of expertise – a group at the FCA, looking at all issues from a conduct perspective, and a second group at the PRA considering prudential issues for PRA authorised firms. Were FCA staff to receive communications in future, similar to those received in 2007-08 in relation to LIBOR lowballing, they would have both the mandate and the expertise to focus on the issue from a purely conduct perspective. The FSA undertook significant reforms since 2008, including a Supervisory Enhancement Programme for high impact firms and the introduction of a new judgement based culture, and has become a more effective organisation now than it was in the review period. We recognise the need to instil cultures in the FCA and PRA that are focused on conduct or prudential risk respectively, but are inquiring and challenging, and take a broad view to all possible risks to statutory objectives. • The PRA's approach will require judgements to be made about risks to a firm's safety and soundness, and to make interventions early before risks crystallise. These judgements will be grounded in analysis, supervisory experience and a strong understanding of the sectors they supervise – gained through direct exposure to the industry. Supervisors will be supported by risk specialists and policy experts who will provide technical expertise to support analysis and supervisory judgements. To support this approach, PRA supervisors, policy experts and risk specialists will focus on key issues, and will be forward looking in regard to risks to financial stability. PRA staff will use their judgement, will question accepted orthodoxies and intervene where they judge necessary.

[5] The PRA has a general objective to *promote the safety and soundness of PRA authorised persons* and an insurance objective of *contributing to the securing of an appropriate degree of protection for those who are or may become policyholders*. The FCA has a general objective to *ensure that the relevant markets function well* and three operational objectives – *securing an appropriate degree of protection for consumers; protecting and enhancing the integrity of the UK financial system; and promoting effective competition in the interests of consumers*.

Lesson 3	Culture of the Regulatory authorities
Management Response (cont)	• The FCA's approach will also be judgement based and pre-emptive, in order to intervene early and prevent risks from crystallising. This approach will be embedded in all of the FCA's front line functions so that there is a common approach through the supervisory cycle from authorisation, to supervision and enforcement. This judgement based approach will be supported by behavioural characteristics of 'curiosity', 'backbone', 'strength as a team', 'already on the case' and 'professional excellence', as set out in the FCA Approach Document. These behaviours will form part of the FCA's performance management framework. • The FCA's approach will also involve increased supervision of wholesale conduct. In the past, the FSA has prioritised retail issues that directly affect consumers over wholesale conduct issues, on the basis that wholesale conduct involves sophisticated parties who are able to look after their own interests. The FSA dedicated substantial resource to wholesale conduct issues where it had a direct mandate to do so (e.g. insider dealing and market abuse) but more generally expected wholesale market participants to abide by high level principles and act in a professional manner. However, lowballing and attempted trader manipulation in respect of LIBOR has highlighted the potential for, and impact of, misconduct within the wholesale markets. To enhance trust and confidence in the integrity of markets, the FCA will take a more assertive and interventionist approach to risks caused by wholesale activities. The CEOs designate of the FCA and PRA have committed to embedding the above behaviours throughout their respective organisations and will conduct reviews for their respective Boards, 12 months from legal cutover, to analyse the effectiveness of this approach.

Lesson 4	Use of information and intelligence
Audit Conclusions	• The FSA should have been more inquiring and challenging of the information in individual communications and more sensitive to the accumulation of the communications. • The FSA should have ensured that communications were analysed, circulated and escalated in an appropriately targeted manner. This would have helped make it clearer what action might be required and by whom, and identify linkages between communications so they could be considered in aggregate. This was particularly the case for information received by supervisors, especially in relation to Barclays (though Audit recognised the supervisor team's competing priorities and resource constraints).
Audit Recommendation	• As an important element in developing the desired culture of the FCA and PRA, alertness to the need to share intelligence appropriately should be reinforced as a principle for all staff behaviour. For the FCA Audit recommend that the new Policy, Risk and Research Division develops clear success measures for its target operating model that take into account the lessons from the review. • FCA and PRA senior management should clarify responsibilities in relation to the use of information from external sources including analysts' reports, media articles and market data.
Management Response	<u>LIBOR</u> In respect of LIBOR specifically, information and intelligence will be co-ordinated within the FCA's Markets Division and, if necessary, referrals will be made to enforcement to bring civil or criminal cases for attempted LIBOR manipulation. Similar information sharing between our Markets and Enforcement Divisions in respect of market abuse and insider dealing has been very successful, with 21 criminal prosecutions, 16 prohibitions and £16.6m in penalties for market abuse over the last five years. As stated on page 12 above, the FCA will establish clear protocols for receiving and managing LIBOR related intelligence from the PRA and Bank of England.

Lesson 4	Use of information and intelligence
Management Response (cont)	FCA The FCA has established a new Policy, Risk and Research Division (PRR) to act as a radar for the new organisation. PRR will bring together information gathering, research and policy making into one place and will drive the actions taken across the organisation. PRR will gather and use a wide range of data, information and intelligence from across the FCA, firms and elsewhere in order to identify and assess risks in financial markets. This will include economic and market analysis, consumer complaints and enquiries, media analysis and intelligence from consumer organisations and professional firms. PRR will place increased emphasis on consumer intelligence, such as consumer intelligence, experiences and concerns, and will pay particular attention to problems with basic products and services. The FCA will also undertake a major overhaul of their data analysis function, with the first phase due to be complete by summer 2013. • We recognise the importance of measuring the success of the new PRR division, and will agree performance metrics for PRR with the FCA Executive Committee by Q3 2013. • We also recognise the importance of ensuring that information and intelligence flows effectively from the wider FCA into PRR, and from PRR back into the wider FCA. In Q4 2013, once the PRR function has been established, we will run cross FCA training sessions to develop best practice for information and intelligence sharing, both into PRR and across the FCA more widely. PRA The PRA will have no responsibilities in respect of LIBOR, and will therefore pass relevant LIBOR information to the FCA. More generally, staff across the PRA and wider Bank of England will receive information and intelligence for the PRA. Regulatory issues will be escalated to an Executive Supervisory and Policy Committee, and where appropriate to the Board of the PRA, and other information and intelligence will be circulated across the PRA and Bank of England as appropriate. The PRA will also form close information sharing relationships across the Bank of England, especially with the Financial Stability and Markets functions.

Lesson 5	Circulation and escalation of information
Audit Conclusions	• The FSA should have ensured that communications were analysed, circulated and escalated in an appropriately targeted manner. This would have helped make it clearer what action might be required and by whom, and identify linkages between communications so they could be considered in aggregate. This was particularly the case for information received by supervisors, especially in relation to Barclays (though Audit recognised the supervisor team's competing priorities and resource constraints).
Audit Recommendation	• The FCA and PRA should establish effective working arrangements for the circulation and sharing of information, including to whom information should be circulated and the action required of the recipient. • The FCA and PRA should establish effective working arrangements for the escalation of information.
Management Response	We recognise that clear guidelines for the circulation and sharing of information, and for the escalation of information to senior management, can have significant benefits for any organisation. Such guidelines help ensure that internal communications are targeted at the most relevant individuals or departments, that senior management receive the information required to execute their responsibilities, and can also help to reduce the frequency of unnecessary communications that can obscure the more important issues. However, we also recognise that formal processes can add a layer of bureaucracy and increase the risk that critical information can remain in silos. Staff training, in particular the creation of a judgement based culture, with a strong awareness of organisational priorities and risk appetite, can also play an important role in ensuring that information is circulated and escalated appropriately. • In response to the Internal Audit findings, we will conduct a short review on the escalation of information within the PRA and FCA. This will allow both regulators to make a judgement on the balance between introducing clear guidelines, high level principles or staff training, in order to improve information flows. • On the specific question of labelling emails (e.g. marking emails as being *For Information* or *For Action*), we agree that clear signposting can have benefits, especially given the large volume of emails received by senior management on a daily basis. Both the PRA and FCA will amend their email management guidelines, and staff induction process, to recommend clear labelling of emails as best practice.

Lesson 6	Records Management
Audit Conclusion	n/a
Audit Recommendation	• Audit recommend that in developing their records management policies, the FCA and PRA include success measures and key performance indicators that take into account the lessons raised in this review and the review's inherent data gathering limitations.
Management Response	During the period under review in the report in 2007/2008 the FSA had a fragmented approach to the storage of records, and as the report highlights this has impeded the effective management of our records. Since then, the FSA has made substantial changes to its records management infrastructure, including the implementation of a new document management system in 2011. This has addressed the issues with searching and retrieval identified in the report. We also focused on the adequacy of record keeping in supervision and, following the creation of our Specialist Supervisory Unit in 2009, we have conducted regular reviews of whether key supervisory records are being properly named, stored, and are easily retrievable. Whilst we have made considerable progress on records management since 2007-08, we recognise the need for vigilance and constant improvement in this area. • We have recently agreed two priorities for records management at the FCA; (i) that each employee will be able to easily find the information they need to perform their role; and (ii) ensuring sensitive information is kept securely. We are reviewing our records management policies and approach to compliance monitoring against these two priorities. In particular, we are emphasising the responsibility of senior management in their area and are ensuring that the Records Management Operations Group, which looks at records management issues at a corporate level, contains senior level representation (Manager or above). • The FCA will carry out compliance checking at both a corporate and local level, against an agreed tolerance threshold to be set by the FCA Executive Operations Committee. The FCA will also explore how better to integrate our email and records management systems to promote greater compliance with our records management policies. This review is due to be complete in June 2013 and may lead to further changes.

	• The PRA will adopt the Bank of England's approach for records management, which utilises the Bank of England's electronic filing system to store and manage electric records. The approach requires staff to include key information about records created and does not facilitate storage of records outside of the central system. Senior business representatives will be given a records management role in line with the Bank of England approach and full training will be given. Management Information will be produced to monitor the appropriate use of records management tools, which will be reviewed by the PRA's Operating Committee.

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