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**Final Notice**

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**To: R. Raphael & Sons Plc  
(FRN: 161302)**

**Date: 12 November 2015**

**ACTION**

1. For the reasons set out in this Notice, the PRA hereby imposes a financial penalty of £1,278,165 on R. Raphael & Sons Plc ("Raphaels") pursuant to section 206 of the Financial Services and Markets Act 2000 (the "Act"), on the basis that Raphaels contravened Principle 3 of the Principles for Businesses between 18 December 2006 and 1 April 2014 (the "Relevant Period").
2. Raphaels agreed to settle at an early stage of the PRA's investigation and therefore qualified for a 30% (stage 1) discount under the PRA's Settlement Policy. Were it not for this, the PRA would have imposed a financial penalty of £1,825,950.

**SUMMARY OF REASONS**

3. Raphaels is a member of a group of companies (the "Group") which includes three other companies, Company A, Company B and Company C. Raphaels is authorised to, amongst other things, accept deposits and is prudentially regulated by the PRA. It provides consumer finance facilities and offers savings accounts. It owns hundreds of ATMs in the UK for public use in locations such as bureaux de change, railway stations and airports. Raphaels also owns mobile ATMs which are used at major sporting and other events.
4. In or around September 2006, Raphaels agreed to enter into a joint venture with Company C for the provision of ATMs in various locations around the UK (the "Joint Venture"). Company A and Company C were to provide various aspects of Raphaels' finance function, including the payment of third parties on behalf of Raphaels arising out of the Joint Venture and replenishment of cash stocks in the ATMs. Raphaels would then reimburse Company A and Company C.

5. No written agreement was entered into at the outset (or for some time thereafter) of the Joint Venture or in relation to the initial outsourced responsibilities.
6. Raphaels failed to carry out suitable due diligence adequately or at all in respect of its outsourcing.
7. Raphaels failed to enter into a written agreement with respect to the outsourced important operational functions until 21 months after Company C had begun to provide some of Raphaels' finance functions. When the written agreement was entered into (and later amended), it did not include any division of responsibilities and powers between Raphaels and Company C or specify appropriate arrangements for Raphaels' oversight of the outsourced function.
8. In or around 2007 to 1 April 2014, the outsourced functions and other functions required under the Joint Venture were provided by a team employed by Company C. Certain employees in this team (the "Employees") had access to Raphaels' bank accounts and improperly transferred funds (in excess of any funds legitimately due from Raphaels to Company C under the Joint Venture for the purposes of reimbursement) without the knowledge or consent of Raphaels, taking steps to conceal their actions ("the Improper Transfers"). For the avoidance of doubt the PRA has seen no evidence to indicate that anyone within the Group, other than the Employees, was aware of or involved in the Improper Transfers. The PRA has also seen no evidence that the Improper Transfers were sanctioned or requested by any Group company or their respective employees and directors.
9. The failings described at paragraphs 5 to 7 above contributed to the ability of the individuals concerned to carry out the Improper Transfers and to the fact that the Improper Transfers went undetected for a significant period of time.

## **SUMMARY OF FACTS AND MATTERS RELIED UPON**

### **Regulatory requirements**

10. The PRA considers that while an authorised firm may outsource important operational functions (for example, for reasons of efficiency or prudent financial management), it may properly do so only if it remains mindful of its regulatory obligations and gives due regard to the impact of the proposed outsourcing on its ability to meet, or continue to meet, such obligations.

11. The PRA expects a prudently managed firm to carry out suitable due diligence on the counterparty to which it intends to outsource and to set appropriate parameters with regard to the division of responsibilities and powers, as well as adequate arrangements for the proper oversight of the outsourced function, all of which should be properly documented. Further, while a firm may outsource the practical aspects of the outsourced function, it may not outsource its regulatory responsibilities as they relate to the outsourced function.

### **The Improper Transfers**

12. Between 2007 and 2010 Company A and Company C increasingly assumed a number of the responsibilities of Raphaels' internal finance function, including the reconciliation of bank and management accounts and the preparation of management information. The formal outsourcing of Raphaels' finance function took place in November 2010.
13. The Improper Transfers were effected to assist Company C to deal with cash-flow issues and therefore, as the funds remained within the Group, the funds were repaid to Raphaels promptly after the discovery of the Improper Transfers. As a result, Raphaels suffered no financial loss or significant detriment as a result of the Improper Transfers.
14. However, the Improper Transfers and the impact on Raphaels' regulatory capital was such that Raphaels was exposed to Company C in such a way that had Company C become insolvent, the impact on Raphaels' own financial position would have been severe.

### **SUMMARY OF FAILINGS**

15. During the Relevant Period, Raphaels failed to:
  - 15.1. outsource important operational functions (namely, those functions that, if defective, would materially impair: the continuing compliance of a firm with the conditions and obligations of its authorisation; its other regulatory obligations; and/or its financial performance) properly and with due regard to its responsibility to ensure there was no detrimental impact on its ability to meet its prudential regulatory obligations as a result of the outsourcing;
  - 15.2. manage the risks associated with and oversee the outsourced important operational functions;

- 15.3. have adequate systems and controls in place which may have:
- 15.3.1. prevented the Improper Transfers from taking place; and
  - 15.3.2. detected in a timely manner the Improper Transfers once they had been effected.
16. These breaches contributed to the ability of the individuals concerned to carry out the Improper Transfers and for them to remain undetected for a prolonged period of time.
17. The breaches also resulted in Raphaels having inadequate oversight and control with regard to its regulatory capital position. A firm's capital position is fundamental to the PRA's assessment of the firm's safety and soundness and the firm's ability to comply with the PRA's Threshold Conditions. During the period May 2011 to November 2013, Raphaels failed to:
- 17.1. understand and report accurately its capital requirement;
  - 17.2. understand and report that it had a large exposure to the Group of more than 10% of its capital resources; and
  - 17.3. understand and report that it had, in 18 months out of 36 during the same period, breached its 25% large exposure limit to the Group. As a result of the Improper Transfers and unknown to Raphaels, at its peak, over 50% of Raphaels' capital, was exposed to the Group.
18. The Improper Transfers resulted in Raphaels having a larger exposure to its Group than it had appreciated and, as such, led to Raphaels submitting incorrect regulatory returns to the FSA and subsequently to the PRA. A firm's correct understanding of its capital position and accurate representation of this in its regulatory returns are of fundamental importance in ensuring the firm's safety and soundness. Accurate disclosure of information by firms is crucial to the PRA's ability to supervise firms effectively and hence to the success of the regulatory system and, by extension, to the stability of the UK financial system.
19. The full particulars of the facts and matters which are relevant to this matter are set out in Annex A. The individual rule breaches which underpin, and/or are supportive of, the breaches of Principle 3 are footnoted in the body of this Notice and are set out in full in Appendix 2.

20. Taking into account the facts and matters set out above and the relevant factors set out in the PRA's Penalty Policy, the PRA considers that the imposition of a financial penalty of £1,825,950 is a reasonable, appropriate and proportionate disciplinary measure in response to Raphaels' breach of Principle 3. However, Raphaels agreed to settle at Stage 1 and therefore qualified for a reduction of the financial penalty to £1,278,165. The basis for this penalty is set out in Annex C.

#### **PROCEDURAL MATTERS**

21. The procedural matters set out in Annex D are important.

#### **DEFINITIONS**

22. The definitions set out in Appendix 2 are used in this Final Notice.

A handwritten signature in black ink, appearing to read "Robert Dedman", is written over a horizontal dotted line.

Robert Dedman  
Chief Counsel, Regulatory Action Division  
for and on behalf of the PRA

# Annex A

## 1. FACTS AND MATTERS RELIED UPON

### 1.1. This section describes:

- 1.1.1. the outsourcing of important operational functions by Raphaels to Company A;
- 1.1.2. the Improper Transfers and their mechanism; and
- 1.1.3. the impact of the Improper Transfers.

### 1.2. **The outsourcing of important operational functions by Raphaels to the Group**

- 1.2.1. Raphaels and Company C decided to undertake the Joint Venture in late 2006. It was also decided in September 2006 that preliminary heads of terms should be drawn up to form the basis of a formal agreement between Raphaels, Company A and Company C; however, no such agreement was drawn up at that time.
- 1.2.2. The first ATM machine pursuant to the Joint Venture became operational in December 2006. Heads of terms were circulated between Raphaels, Company A and Company C on 27 March 2007 and further iterations were circulated between the parties during the course of 2007 and 2008. A formal legal agreement was created in draft and circulated on 1 May 2007, but it was never executed.
- 1.2.3. An unsigned outline of the Joint Venture and a general outline of those matters to be outsourced was submitted to Raphaels' internal audit function in September 2008 to evidence to internal audit that a written agreement was in place as between the parties (and therefore that Raphaels was in compliance with its regulatory responsibilities). However, the document was not signed by the parties until during or about December 2008 (the "First Outsourcing Agreement"), although it was backdated to 1 March 2007.
- 1.2.4. The division of responsibilities under the First Outsourcing Agreement was stated to be as follows:

- 1.2.4.1. Raphaels was responsible for preparing management accounts for its part of the Joint Venture and for distributing any profit to, or allocating any loss between, itself, Company A and Company C.
- 1.2.4.2. Company C was responsible for managing the cash required to load each ATM: "*undertak[ing] [the] reconciliation of the cash in the ATMs and the income generated by ATM usage*" and for "*supply[ing] any MIS [management information] necessary for FSA reporting by Raphaels - for example liquidity reporting*".
- 1.2.5. This was the first element of the outsourcing by Raphaels of part of its finance function to the Group; specifically, that part of the finance function which related to the Joint Venture's operation of the ATMs (the "ATM Finance Function"). It was also stated that the agreement would be reviewed annually on its anniversary.
- 1.2.6. The First Outsourcing Agreement was revised by way of a written agreement dated 1 March 2009, but not signed until around August 2009 (the "Second Outsourcing Agreement"). The revisions concerned the profit share between the parties. Company A was not a party to the Second Outsourcing Agreement or any subsequent amendment agreements.
- 1.2.7. The services provided by Company C during 2007 to 2009 were, in fact, more extensive than provided for by the First and Second Outsourcing Agreements. In effect, Company C was providing the majority, if not all, of Raphaels' finance services relating to the ATM Finance Function during this period.
- 1.2.8. The Second Outsourcing Agreement was revised by way of a written agreement between Raphaels and Company C only, dated 1 March 2010 but only signed around August 2010 (the "Third Outsourcing Agreement"). The terms were substantively similar to the previous two agreements but with the addition of the following term: "[Company C] *also provides cash management, settlement and reconciliation services for Raphaels*".

- 1.2.9. The Third Outsourcing Agreement was then revised by an agreement dated 1 March 2011 which was signed around May 2012 (the "Fourth Outsourcing Agreement"). The Fourth Outsourcing Agreement contained greater detail concerning the services provided and the obligations of Raphaels and Company C in relation to the operational aspects of the Joint Venture. However, the Fourth Outsourcing Agreement provided no established method for controlling or verifying the accuracy of the amounts transferred from Raphaels to Company C which, in part, constituted the Improper Transfers.
- 1.2.10. The ATM Outsourcing Agreements did not provide for the oversight by Raphaels of the outsourced services, including the provision of the ATM Finance Function. Furthermore, Raphaels did not, in fact, monitor Company C's provision of the ATM Finance Function.
- 1.2.11. A further outsourcing agreement for the provision of accounting services was later entered into between Raphaels and a further sister company, Company B, and was effective from 1 November 2010 (the "Finance Function Outsourcing Agreement"). The Finance Function Outsourcing Agreement allocated responsibility to Company B for, amongst other things, the following key matters (cumulatively the "Finance Function"):
- 1.2.11.1. the production of Raphaels' monthly management accounts, including summary profit and loss by division, a consolidated profit and loss account, divisional balance sheets and a consolidated balance sheet;
  - 1.2.11.2. ensuring reconciliations were kept up to date or brought up to date in accordance with agreed timescales, with weekly reports to be submitted in the interim;
  - 1.2.11.3. to "*provide support*" in automated liquidity reporting and automated regulatory reporting; and
  - 1.2.11.4. to provide payment services for Raphaels in accordance with approved delegated authorities.
- 1.2.12. Notwithstanding that the ATM Outsourcing Agreements and the Finance Function Outsourcing Agreement were between Raphaels



and Company C and Raphaels and Company B respectively, both the ATM Finance Function and the Finance Function which were governed by those agreements reported to a team containing the Employees employed by Company C.

### **1.3. The Improper Transfers**

1.3.1. Company C was responsible for, amongst other things:

1.3.1.1. refilling a number of the ATMs with the remaining ATMs being refilled directly by other providers who would raise invoices directly with Raphaels ("Third Party Suppliers");

1.3.1.2. the management of the Third Party Suppliers' invoices under the ATM Outsourcing Agreements;

1.3.1.3. effecting payment instructions on behalf of Raphaels (the Employees had direct access to Raphaels' bank accounts for this purpose); and

1.3.1.4. performing the accounting entries for the accounts of both Company C and Raphaels that resulted from cash transactions between Raphaels and Company C and as between Raphaels and Third Party Suppliers.

1.3.2. However, the Improper Transfers were carried out by the Employees manipulating payments, without Raphaels' knowledge, due to Company C from Raphaels for filling Raphaels' ATM machines pursuant to the Joint Venture. This was done to provide additional cash liquidity for Company C.

#### **The Mechanism for the Improper Transfers**

1.3.3. The mechanism for the Improper Transfers was as follows:

1.3.3.1. on a daily basis, a calculation would be made by the Employees as to how much cash was required to refill Raphaels' ATMs. Company C's working cash requirement would also be calculated. If Company C required additional liquidity, the sum due to Company C from Raphaels would be artificially inflated by that amount by

the Employees. A payment instruction would then be raised by the Employees to transfer the money from Raphaels to Company C and, as the Employees had access to Raphaels' bank accounts, authorise the improper transfer. There was no oversight by Raphaels of this payment process.

- 1.3.3.2. In order to periodically reduce the amount owing from Company C to Raphaels arising from the Improper Transfers, the amount of cash required to refill the ATMs would be artificially reduced with the resulting shortfall being made up with Company C's cash. This reduced the outstanding intercompany balance that arose due to the Improper Transfers.

#### **Accounting treatment of the Improper Transfers**

- 1.3.4. As a result of the Improper Transfers, an intercompany balance would build up as between Company C and Raphaels, equal to the amount outstanding under the Improper Transfers plus any legitimate balance as owing between the companies.
- 1.3.5. In the period prior to August 2010, the intercompany balance owing from Company C to Raphaels that arose due to the Improper Transfers was recorded as an amount owing from Company C to Raphaels in both the accounts of Company C and Raphaels. However, after August 2010, steps were taken by the Employees to disguise the intercompany balances that were arising as a result of the Improper Transfers. In summary:
  - 1.3.5.1. Monthly journal entries were made by the Employees to move an amount approximately equivalent to the value of the Improper Transfers for that month from Raphaels' Company C intercompany account into other Raphaels' balance sheet accounts (including Visa, Link and MasterCard).
  - 1.3.5.2. Prior to April 2013, Company C's accounting entries for the Improper Transfers were not moved via balance sheet transfers to other balance sheet accounts. This resulted

in an intercompany balance owing from Company C to Raphaels and a divergence between Raphaels' and Company C's stated intercompany balances. After April 2013, the intercompany balance arising from the Improper Transfers was moved to another balance sheet account.

### **Extent of the Improper Transfers**

1.3.6. Although there is information to suggest that the Improper Transfers took place from around 2007, the available records span only the period 1 March 2010 to 1 March 2014. The largest balance of the Improper Transfers during each financial year is set out below:

2011: £5,417,000

2012: £4,122,000

2013: £6,450,000

2014: £9,223,500

### **Large Exposure error**

1.3.7. An authorised firm is required to disclose to the regulator (in this case, the FSA and subsequently the PRA) in its quarterly returns a total exposure to any group of which it is a member (or to any third party or connected parties) of equal to or greater than 10% of its regulatory capital. During the relevant period there was a prohibition on a firm having a total exposure to its group (or any third party or connected parties) of greater than 25% of its regulatory capital.

1.3.8. During the period May 2011 to November 2013 (and excluding any impact of the Improper Transfers), Raphaels only reported its exposure to Company A as a result of various loans, but did not report its total exposure to Company A and to other members of the Group via intercompany balances and other such exposures. As a result of this error, in eight quarterly returns out of 11 during the period May 2011 to November 2013, the intercompany balances to the Group should have been reported to the FSA by Raphaels as a large exposure (regardless of the Improper Transfers).

## **Regulatory impact of the Improper Transfers**

- 1.3.9. When the Improper Transfers are taken into account in determining Raphaels' total exposure to the Group, it is clear that Raphaels had a large exposure (namely 10% of its capital) to the Group on every quarterly reporting date but did not report this in its regulatory returns.
- 1.3.10. In addition, Raphaels was in breach of the 25% large exposure limit on 5 out of the 11 quarterly reporting dates during this period. Moreover, as the 25% large exposure limit is a continuing obligation (and not an obligation to comply only on reporting dates), when looked at on a monthly basis using data from management accounts, Raphaels unintentionally breached the 25% large exposure limit on 20 months out of 36 (over the period May 2011 to February 2014).
- 1.3.11. As between May 2011 and November 2013 and pursuant to the accounting treatment of the Improper Transfers, Raphaels treated the Improper Transfers to be balances owing to Visa, Link and MasterCard for the purposes of its capital calculation and reporting requirements they were treated as a credit risk with a weighting requirement of 20%. This reflected the inaccurate and misleading entries made in Raphaels' accounts as described above at paragraphs 1.3.4 and 1.3.5.
- 1.3.12. However, the Improper Transfers should have been correctly accounted for as exposures to the Group and would have therefore attracted a 100% risk weighting under Raphaels' capital and reporting requirements. As such, Raphaels unintentionally under-reported its capital requirements as a result of the Improper Transfers.

## **1.4. Raphaels' finance function**

- 1.4.1. At different points during the relevant period Raphaels' auditors identified issues with the outsourced finance function (of which the ATM function was part) including in relation to accounting processes and reconciliations between Group companies. The auditors identified a number of risks in the operation of the finance function. These issues and risks were highlighted in audit reports and discussed at

Board meetings. Some of the issues were raised by the auditors on more than one occasion.

## **1.5. Raphaels' reaction on discovering the Improper Transfers**

- 1.5.1. On discovery of the Improper Transfers, Raphaels commissioned a leading firm of accountants to report on the matter and a subsequent review under section 166 of FSMA gave a Reasonable Assurance opinion on Raphaels' current systems and controls at that time.
- 1.5.2. Although the PRA is aware that, upon becoming aware of the Improper Transfers, the Bank undertook significant and timely remedial action to address the issues that had been identified, the PRA considers this to be the action to be expected of an authorised firm in the circumstances. This action included:
  - 1.5.2.1. the termination of a number of intra-group contracts (within seven days of the discovery of the Improper Transfers) and the putting in place of certain new contracts (within three weeks of the discovery);
  - 1.5.2.2. transferring the relevant Finance teams that had been employed by Company A back to the Bank, within one month of the discovery of the Improper Transfers;
  - 1.5.2.3. undertaking a Bank wide review of all outsourcing arrangements; and
  - 1.5.2.4. ensuring complete operational separation of the Bank from the rest of the group within seven months of the discovery of the Improper Transfers.

# Annex B

## **BREACHES AND FAILINGS**

The facts and matters to which the following conclusions relate are set out in Annex A. The relevant statutory and regulatory provisions relating to this Final Notice are set out in Annex D.

### **1. Principle 3 breaches**

- 1.1. Raphaels breached Principle 3 on the grounds that it failed to outsource properly and with due regard to its regulatory responsibilities; it did not adequately oversee or manage the outsourcing of important operational functions; and it failed to report accurately to the FSA and subsequently to the PRA its liquidity position, its capital position and its exposure to the Group.
- 1.2. The Outsourcing Agreements did not appropriately set out the roles and responsibilities of each party. The failings in the control environment in which the Improper Transfers were effected resulted in Raphaels having no accurate measure of its capital or its exposures to the Group; for example, on three occasions during the Relevant Period, it had an exposure to its Group that was in excess of 50% of its capital resources.
- 1.3. Raphaels consistently unintentionally misreported its capital position to the FSA and the PRA, which impacted detrimentally upon the regulators' ability to supervise the firm effectively and to make appropriate regulatory judgments.
- 1.4. These failings can be summarised as falling into two broad categories that are set out below:
  - 1.4.1. failures in the outsourcing; and
  - 1.4.2. large exposure and regulatory reporting failures.

### **2. Failures in the Outsourcing**

- 2.1. From December 2006, when the first ATM became operational until the First Outsourcing Agreement was signed during or about December 2008, Raphaels did not ensure that the respective rights and obligations of Raphaels

and Company C and Company A, as service providers of an important operational function, were clearly allocated in a written agreement. The absence of a formal written agreement<sup>1</sup> meant that there was no clear allocation of responsibilities or implementation of an effective oversight structure that all parties understood.

2.2. Raphaels failed to take reasonable care when entering into and when managing the arrangement for the outsourcing to Company C of important operational functions.<sup>2</sup> When the ATM Outsourcing Agreements were executed, they were materially deficient in setting out the rights and obligations of the respective parties<sup>3</sup>. In particular, they did not:

2.2.1. establish a mechanism or terms for Raphaels to supervise Company A and/or Company C effectively or at all;<sup>4</sup>

2.2.2. set out service level agreements or methods of measuring the efficacy of the outsourced function;<sup>5</sup> and

2.2.3. accurately capture the extent of the services that were, in fact, provided by Company A or Company C during this period.<sup>6</sup>

2.3. Raphaels failed to ensure that Company C properly supervised the carrying out of the outsourced function and that Company C adequately managed the risks associated with the outsourcing.<sup>7</sup> As detailed above, these risks contributed to the ability of the Employees to carry out the Improper Transfers and for them to remain undetected for a prolonged period of time.

2.4. While steps were taken to address a number of the issues raised by the auditors in relation to the outsourced finance function, the fact that the issues appeared to recur should have prompted Raphaels to review the overall operation of its finance function and its approach to outsourcing.

2.5. The PRA considers that had Raphaels outsourced with reasonable care and with appropriate checks and oversight, the Improper Transfers may not have

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<sup>1</sup> SYSC 8.1.9R

<sup>2</sup> SYSC 8.1.7R

<sup>3</sup> SYSC 8.1.9R

<sup>4</sup> SYSC 8.1.9R

<sup>5</sup> SYSC 8.18(1)R

<sup>6</sup> SYSC 8.18(1)R

<sup>7</sup> SYSC 8.1.8R

occurred or, in the event that they had occurred, that they would not have remained undetected for so long. Further, this may also have been the case had Raphaels acted more effectively to address the various issues identified (as set out above) and to mitigate the obvious risks in these areas.

### **3. Liquidity, Capital and Reporting**

3.1. As set out in paragraphs 1.3.7 to 1.3.12 of Annex A above, Raphaels failed to take reasonable steps to ensure that it had appropriate systems and controls to ensure that the information which it provided to the FSA and PRA was:

3.1.1. factually accurate or, in the case of estimates and judgments, fairly and properly based after appropriate enquiries have been made by Raphaels;<sup>8</sup> and

3.1.2. complete, in that it should include anything of which the FSA or PRA would reasonably expect notice<sup>9</sup>.

3.2. Raphaels failed to submit all the required information to the FSA or PRA. In particular, Raphaels only reported its loan balances to the Group and not its total exposures to the Group; for example, intercompany balances.

3.3. The result of these breaches was that the FSA and the PRA had an incomplete and erroneous understanding of: the risks that Raphaels was exposed to; its capital adequacy; and ultimately the extent to which it complied with the PRA's Threshold Conditions (and, in particular, whether it had adequate financial resources). These matters go to the heart of the PRA's ability as a prudential regulator to achieve its general objective of promoting the safety and soundness of the firms which it regulates.

### **4. Conclusion**

4.1. Raphaels breached Principle 3 as it failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. Specifically, it:

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<sup>8</sup> SUP15.6.1(1)R

<sup>9</sup> SUP 15.6.1(2)R



- 4.1.1. failed to implement, manage and oversee the Outsourcing Agreements appropriately and effectively;
  - 4.1.2. failed to consider, identify or mitigate the risks inherent in the Outsourced Functions; and
  - 4.1.3. failed to accurately monitor and oversee Raphaels' liquidity position, correctly monitor its exposures to the Group and report that liquidity position to the FSA and PRA.
- 4.2. Raphaels' failures contributed to the Improper Transfers being effected and remaining undetected over a prolonged period, which, together with the provision of inaccurate and misleading capital liquidity reporting, detrimentally impacted upon the PRA's ability to discharge effectively its regulatory and supervisory functions.

## Annex C

### 1. PENALTY FRAMEWORK

- 1.1. The breaches of Principle 3 occurred from 18 December 2006 to 1 April 2014. Prudential regulation of Raphaels transferred to the PRA on 1 April 2013. As the breaches continued after 1 April 2013, pursuant to article 11(6)(b) of the Transitional Provisions Order, the PRA must apply its penalty regime as set out in the PRA's Penalty Policy.

#### Step 1: disgorgement

- 1.2. Raphaels derived no economic benefit, nor made any profit or avoided any loss, as a result of the breaches. The Step 1 figure is therefore **£0**.

#### Step 2: seriousness of the breach

##### Relevant revenue

- 1.3. Paragraph 18 of the PRA's Penalty Policy states that the PRA will determine a Step 2 figure for a punitive penalty having regard to the seriousness of the breach by the firm; and a suitable indicator of the size and financial position of the firm. In this instance the PRA has determined that revenue is an appropriate indicator.
- 1.4. Paragraph 19(b) states that where revenue is an appropriate indicator, ordinarily the PRA will calculate '*the firm's revenue during its last business year, that is, the financial year preceding the date when the breach ended*' ("Relevant Revenue"). Raphaels' Relevant Revenue is therefore revenue during the financial year ending 28 February 2014. In determining Raphaels' Relevant Revenue, the PRA has reviewed Raphaels' audited financial statements.
- 1.5. Based on this information, the Relevant Revenue is **£12,173,000**.
- 1.6. To arrive at the penalty the PRA has adopted the approach set out in the PRA's Penalty Policy.
- 1.7. The PRA has taken the following factors into account to determine the Step 2 amount:

- 1.7.1. Raphaels did not carry out suitable due diligence on Company A and Company C. It did not put in place any written terms until 21 months after Company A and Company C had started to undertake the provision of some finance functions for Raphaels.
- 1.7.2. When a written agreement was put in place (and later amended), it did not set appropriate parameters as between Raphaels and Company C or set appropriate arrangements for Raphaels' oversight of the outsourced function.
- 1.7.3. The Improper Transfers resulted in Raphaels having a larger exposure to Company A than it realised and, as such, led to the submission of incorrect data to the FSA and PRA via Raphaels' regulatory returns.
- 1.7.4. The accuracy of a firm's capital position and an accurate representation of this via its regulatory returns to the PRA are of fundamental importance in ensuring a bank's safety and soundness. Accurate disclosure of information by firms is crucial to the PRA's ability to supervise effectively and hence to the success of the regulatory system.
- 1.7.5. As indicated above, Raphaels' auditors identified issues and risks in relation to the operation of its outsourced finance function. Where these issues were dealt with, it appears this occurred in isolation (and in some cases the same issue was raised again in the subsequent audit report), rather than prompting Raphaels to review the overall operation of its finance function and its approach to outsourcing.
- 1.7.6. The scale of the misappropriation of cash was such that a significant proportion of Raphaels' capital was at risk in the event of the Group's failure and such a failure would have had a significant adverse impact on Raphaels' financial soundness. However, the PRA acknowledges that the breaches did not result in the disruption of the continuity of financial services and did not have any impact on Raphaels' reported performance.

- 1.8. On this basis, the PRA considered that a seriousness factor of 15% should be applied to the Relevant Revenue and, therefore, the Step 2 figure is **£1,825,950**.

### **Step 3: mitigating and aggravating factors**

- 1.9. The PRA considered that there were no relevant aggravating or mitigating factors and no adjustment to the Step 2 figure. Therefore, the Step 3 figure is **£1,825,950**.

### **Step 4: adjustment for deterrence**

- 1.10. If the PRA considers the penalty determined following Steps 2 and 3 is insufficient to effectively deter the firm that committed the breach and others who are subject to the PRA's regulatory requirements from committing similar or other breaches, it may increase the penalty at Step 4 by making an appropriate deterrence adjustment to it.
- 1.11. The PRA did not consider an adjustment for deterrence to be appropriate in this instance. The Step 4 figure is therefore **£1,825,950**.

### **Step 5: settlement discount**

- 1.12. Pursuant to paragraph 29 of the PRA's Penalty Policy, if the PRA and the firm on whom a penalty is to be imposed agree the amount of the financial penalty and other terms, paragraph 26 of the PRA's Settlement Policy provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the PRA and the firm reached agreement (as set out at paragraph 28 of the PRA Settlement Policy).
- 1.13. As the PRA and Raphaels were able to reach agreement at Stage 1, a 30% discount was applied to the Step 4 figure.
- 1.14. The Step 5 figure is therefore **£1,278,165**.

# Annex D

## PROCEDURAL MATTERS

### 1. Decision-maker

1.1. The settlement decision-makers made the decision which gave rise to the obligation to give this Notice.

1.2. This Final Notice is given under and in accordance with section 390 of the Act.

### 2. Manner of and time for payment

2.1. The financial penalty must be paid in full by Raphaels to the PRA no later than 14 days from the date of this Notice.

### 3. If the financial penalty is not paid

3.1. If all or any of the financial penalty is outstanding on the day after the due date for payment, the PRA may recover the outstanding amount as a debt owed by Raphaels and due to the PRA.

### 4. Publicity

4.1. Sections 391(4), 391(6A) and 391(7) of the Act apply to the publication of information about the matter to which this Notice relates. Under those provisions the PRA must publish such information about the matter to which this notice relates as the PRA considers appropriate. The information may be published in such manner as the PRA considers appropriate. However, the PRA may not publish information if such information would, in the opinion of the PRA, be unfair to the person with respect to whom the action was taken or prejudicial to the safety and soundness of PRA-authorized persons.

### 5. PRA contacts

5.1. For more information concerning this matter generally, contact Jim Calveley at the PRA (direct line: 020 7601 8534 / fax: 020 7601 4771).

# APPENDIX 1

## DEFINITIONS

**The definitions below are used in this Final Notice:**

"the Act" means the Financial Services and Markets Act 2000;

"ATM" means automated teller machine;

"the ATM Outsourcing Agreements" means the First Outsourcing Agreement, the Second Outsourcing Agreement, the Third Outsourcing Agreement and the Fourth Outsourcing Agreement;

"the FCA" means the body corporate known as the Financial Conduct Authority;

"the FSA" means the body corporate known until 1 April 2013 as the Financial Services Authority;

"Handbook" means the PRA's Handbook as in force during 1 April 2013 and now replaced by the PRA Rulebook;

"LCO" mean Legal Cutover – being the date on which the FCA and PRA came into existence i.e. 1 April 2013;

"Notice" means the PRA's Final Notice;

"Outsourced Functions" means the outsourcing of the ATM Finance Function and Raphaels Finance Function;

"the PRA" means the body corporate known as the Prudential Regulation Authority;

"the PRA's Penalty Policy" means "The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure April 2013 – Appendix 2 – Statement of the PRA's policy on the imposition and amount of financial penalties under the Act";

"the PRA's Settlement Policy" means "The Prudential Regulation Authority's approach to enforcement: statutory statements of policy and procedure April 2013 – Appendix 4 – Statement of the PRA's settlement decision-making procedure and policy for the

determination and amount of penalties and the period of suspensions or restrictions in settled cases”<sup>10</sup>;

“Principle” means: in relation to the period prior to 1 April 2013 the FSA’s Principles for Businesses; and on or after that date, the PRA’s Principles for Businesses;

“Threshold Conditions” means The PRA’s statutory Threshold Conditions, set out in Part 1E of Schedule 6 to the Act which set out the minimum requirements that firms must meet in order to be permitted to carry on the regulated activities in which they engage;

“the Transitional Provisions Order” means the Financial Services Act 2012 (Transitional Provisions) (Enforcement) Order 2013; and

“the Tribunal” means the Upper Tribunal (Tax and Chancery Chamber).

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<sup>10</sup> <http://www.bankofengland.co.uk/publications/Documents/other/praproachenforcement.pdf>

# APPENDIX 2

## RELEVANT STATUTORY AND REGULATORY PROVISIONS

1. References in this notice to provisions in the PRA's Handbook, and its Principles for Businesses, are to:
  - 2.1 the FSA's Handbook prior to 1 April 2013; and
  - 2.2 the PRA's Handbook, and Principles, on and after that date (now supplanted by the Fundamental Rules in the PRA's Rulebook).
2. Principle 3 of the PRA's Principles for Businesses (which were in force until 19 June 2014) stated that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
3. SYSC 4.1.1R states that a firm must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems.
4. SYSC 8.1.1R states, amongst other things, that a firm must not undertake the outsourcing of important operational functions in such a way as to impair materially:
  - 4.1.1. the quality of its internal control; and
  - 4.1.2. the ability of the regulator to monitor the firm's compliance with all obligations under the regulatory system and, if different, of a competent authority to monitor the firm's compliance with all obligations under MiFID<sup>11</sup>.
5. SYSC 8.1.7R states that a common platform firm must exercise due skill and care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any relevant services and activities.

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<sup>11</sup> The European Parliament and Council Directive on markets in financial instruments (No. 2004/39/EC).



6. SYSC 8.1.8R states that a common platform firm must in particular take the necessary steps to ensure that the following conditions, inter alia, are satisfied:
  - 6.1.1. the service provider must carry out the outsourced services effectively, and to this end the firm must establish methods for assessing the standard of performance of the service provider; and
  - 6.1.2. the service provider must properly supervise the carrying out of the outsourced functions, and adequately manage the risks associated with the outsourcing.
7. SUP 15.6.1R states that a firm must take reasonable steps to ensure that all information it gives to the FSA in accordance with a rule in any part of the Handbook (Including Principle 11) is:
  - 7.1.1. factually accurate or, in the case of estimates and judgments, fairly and properly based after appropriate enquiries have been made by the firm; and
  - 7.1.2. complete, in that it should include anything of which the FSA would reasonably expect notice.
8. SUP 16.3.11R states that a firm must submit reports required under SUP to the FSA and the PRA containing all the information required.
9. BIPRU 10.5.6 states that a firm must ensure that the total amount of its exposures to the following does not exceed 25% of its capital resources (as determined under BIPRU 10.5.2 R, BIPRU 10.5.3 R and BIPRU 10.5.5 R):
  - 9.1.1. a counterparty; or
  - 9.1.2. a group of connected clients; or
  - 9.1.3. its connected counterparties.
10. Article 395 of the Capital Requirements Regulation<sup>12</sup> states that an institution shall not incur an exposure, after taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403, to a client or group of connected clients the value of which exceeds 25 % of its eligible capital.

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<sup>12</sup> The European Parliament and Council Regulation on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (No 2013/575/EC)