A guide to the FCA’s supervisory approach for all firm classifications

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A GUIDE TO FCA SUPERVISION

The FCA’s approach to supervision centres around their statutory objectives: consumer protection, market integrity and competition; this approach focuses on judgement based supervision with a view to preventing consumer detriment before it occurs. With a series of regulatory failures under the watch of their predecessor, we have already seen that the FCA is keen to take swift and decisive action against firms at an early stage.

With consumer outcomes of fundamental importance to the FCA, the degree of regulatory intrusion will depend on the category of firm that is being supervised, with the FCA deploying their supervisory teams accordingly.

The model involves building the FCA’s supervision around three clear pillars, each of which has a distinct purpose.

FCA supervisors are focused on conducting in-depth and structured supervision work on those firms with the greatest potential to cause risks to consumers or market integrity. This means that certain firms in some sectors may experience a highly intensive level of contact with supervisors over months or even years, whereas others may only be contacted once every four years.

As mentioned above, the FCA is keen to prevent consumer detriment, rather than dealing with the after effects, and therefore believes that the emphasis should sit with a firm’s business model. A new Business Model Threshold Condition has been introduced which allows the regulator to look at a firm’s strategy and business model and requires the firm to place customers’ interests at the forefront of what they do. The level of supervisory intrusion that a firm experiences will depend upon their firm categorisation.

CONDUCT SUPERVISION CATEGORIES

Firms regulated by the FCA for conduct have been categorised and all firms will have been notified of their categorisation class.

There are four classes of categorisation, and a firm’s class is based on the impact it may have on FCA’s objectives and the number of retail customers it has. Broadly the categories are:

- **C1**: banking and insurance groups with a very large number of retail customers and investment banks with very large client assets and trading operations
- **C2**: firms across all sectors with a substantial number of retail customers and/or large wholesale firms
- **C3**: firms across all sectors with retail customers and/or a significant wholesale presence
- **C4**: smaller firms, including almost all intermediaries
THREE PILLARS OF SUPERVISION

The FCA is focusing their attention on firms and sectors of the industry that could cause, or are causing, consumers harm or threaten market integrity. Their supervision model is built on three pillars:

1. Firm Systematic Framework (FSF)
2. Event Driven Work
3. Issues and Product Work

1. Firm Systematic Framework (FSF)

The FSF is preventative work through structured conduct assessments. It replaces the FSA’s ARROW visits and is where the FCA assesses whether a firm is being run, currently and prospectively, in a way that results in the fair treatment of customers and minimises risks to market integrity. FSF aims to identify potential and emerging conduct risks including their drivers to enable earlier intervention (i.e. stopping risks from crystallising and causing detriment to customers).

The key questions the FSF is designed to answer are:

- **Is the firm run in a way that results in the fair treatment of its customers?**
- **What are the causes of any deficiencies in its fair treatment of its customers?**
- **What does the firm need to do to rectify these underlying causes and deficiencies?**

Common features of the FSF involve:

**Business Model and Strategy Analysis (BMSA)**

The FCA uses their Business Model and Strategy Analysis (BMSA) to identify the conduct risks that may be inherent in the business model of the firm and to give a view on how sustainable the business model is. This will be tied in to the Business Model Threshold Condition which will now form part of the authorisation process.

**Assessment of How a Firm Embeds Fair Treatment of Customers and Ensures Market Integrity**

The FCA wants to understand how a firm assesses risk at the present time and also how it will be reviewed as the business evolves and develops its future. In addition, the FCA wants to understand how the Board is involved in the process and is kept appraised of developments. The FCA aims to do this by using the following four assessment modules:

1. **Governance and culture** - how does the firm identify, assess, manage and reduce conduct risk
2. **Product design** - determine whether a firm’s products and services meet customer needs and are targeted accordingly
3. **Sales or transaction processes** - assessment of a firms’ systems and controls
4. **Post-sales/services and transaction handling** - assessment of how effectively a firm ensures ongoing fair treatment of its customers including complaints handling.

Deciding what actions are required by the firm - to address any identified deficiencies.

**Communication to the firm** - outlining the outcomes of the assessment and advising on actions required.
These assessments will help the FCA to come to a view about the extent to which a firm embeds the fair treatment of customers and integrity in the way in which it is run. The assessment of governance and culture will be crucial as these are the key factors that drive whether a firm treats its customers fairly and can achieve the consumer outcomes set out through the TCF initiative.

2. Event Driven Work
Event driven supervision is intended to deal with issues that are emerging, have happened, or are unforeseen in their nature. These could be issues that are crystallising, or have already crystallised and where the FCA may be seeking redress. Event driven work is of high importance to the FCA and critical to their objectives. It is in this area that the FCA will (as already demonstrated) be acting faster and more decisively than before.

3. Issues and Product Work
It is under issues and products work that we will see the FCA’s thematic supervision. This allows them to address key conduct priorities at the issue and product level. The regulator will draw on data analysis, market intelligence and input from the firm assessment process. Here, we expect to see the FCA using their new intervention powers by intervening early to mitigate and remedy emerging risks before they cause widespread detriment across the sector. Findings and remedial action will usually be extended to all firms that might be affected by the risk in question, not just those directly involved in the project.

This new approach is still in its infancy and it will be interesting to see how it develops over time. In the meantime, firms would do well to take a good look at their business model, and ensure that it will stand up to in-depth scrutiny when their FCA visit occurs.

CONDUCT CATEGORISATION

Conduct categorisation is the way in which the FCA classifies firms according to the risk they pose to their objectives and indicates how a firm will be supervised.

C1 Firms
C1 firms have been classed as ‘fixed portfolio’, which means they have a dedicated supervisor, and can expect ‘proactive supervision’ on a 2 year cycle.

C1 firms will have business model and strategy analysis carried out on a firm-by-firm basis, in the context of the market in which they operate with the aim of identifying the conduct risks that may be inherent in the business model, using a ‘follow the money’ approach.

They will experience proactive supervisory engagement through meetings with senior management, the gathering of management information and analysis of emerging risks.

C1 firms can also expect deep dives into certain areas where the FCA needs more in-depth work undertaken - these could, for example, be on a firm's product governance or sales processes.

C2 Firms
Like C1 firms, C2 firms have been classed as ‘fixed portfolio’, which means they also have a dedicated supervisor, and can expect ‘proactive supervision’ on a 2 year cycle.

The FCA will carry out the business model and strategy analysis on a group of similar firms in the same industry sector to identify common risks.
Firms will experience proactive supervisory engagement through meetings with senior management, the gathering of management information and analysis of emerging risks.

C2 firms can also expect deep dives into certain areas where the FCA needs more in-depth work undertaken - these could, for example, be on a firm's product governance or sales processes.

C3 Firms

C3 firms will be classed as ‘flexible portfolio’ which means they will be supervised by a team of sector specialists and not have a dedicated supervisor.

The FCA will look at a sample of firms’ business models across a sector. The FCA will examine C3s’ business models, but will be looking more at firms which are outliers compared to their peers. The detailed assessment for C3s will be a focused review of their business, how it is run and how it is controlled. The assessment will be followed by a feedback letter setting out key findings and actions to be undertaken by the firm.

The firm-specific assessment for C3 firms will be on a 4 year cycle; however, the FCA will conduct interim reviews of firms where information indicates that the risk they represent is significantly changing.

C4 Firms

C4 firms will also be classed as ‘flexible portfolio’ firms which means they will be supervised by a team of sector specialists and not have a dedicated supervisor.

C4s will have their business models assessed when the FCA looks at how the firm runs its business, but this will be a lighter assessment than for C3s.

The FCA will want to see how firms identify and take action to reduce risks to their business. The six consumer outcomes set out in the TCF initiative still feature highly and the FCA expects smaller firms to continue to strive to achieve these outcomes.

All firms assessed as ‘high-risk’ and around 25% of firms deemed to be medium-high risk will have a face-to-face interview. The FCA will provide verbal feedback at the interview, followed by a letter setting out any action points which will need to be addressed by the firms’ senior management.

C4s will have a touch point every four years, which could range from a road show, an interview, a telephone call, an online assessment, or a combination of these. The exact interaction will depend on the FCA’s assessment of the risk such firms pose to its objectives.
REGULATORY TOOLS

The FCA will put the responsibility on firms to do their own monitoring on some of the less onerous points and to self-attest that they have been addressed. They will use a number of tools to ensure this happens, such as section 166 skilled person’s reports, internal audit review and non-executive director reports.

WHAT SHOULD FIRMS DO NOW?

Firms must ensure that they are placing their customers interests at the heart of everything they do and take measures to be able to evidence this to the regulator when they come knocking.

Business Model

The Business Model Threshold Condition enables the FCA to look at a firm’s business as a whole – not just their regulated activities. This new Threshold Condition must be met at the outset, from authorisation and throughout a business’ lifetime.

The FCA’s approach to supervision will typically start with a firm specific Business Model and Strategy Analysis (BMSA), which will be used to assess a firm’s exposure to risk as well as being used to identify the areas to be examined in the assessment stage of the FSF and through the FSF modules.

Firms must ensure that they are able to demonstrate that their business model, strategy and underpinning this, their culture, places the customer first. It is about doing the right thing, not just ticking boxes. The FCA’s BMSA should highlight the areas in your firm that pose the biggest risk to consumers, therefore this should be an initial area of focus for firms.

Service Proposition

Firms must be clear about the service they are offering and make sure that they are delivering what the client thought they signed up for. The exact nature of the agreement, as well as how the customer will pay for it should be agreed up front, with a client agreement signed at the start of the business relationship. Although this was central to the RDR and could now be viewed as ‘old news’, recent reviews conducted by the regulator demonstrate that disclosure is still not adequate in many firms across the industry.

Suitability

Suitability continues to be a real problem. It has plagued legacy business. Despite abundant guidance from many sources, including the regulator, this is an area that firms need to focus their attention on. TCC’s advice is to:

- Record and keep up-to-date customer information to ensure customers’ investments remain suitable;
- Ensure records are current and relevant;
- Ensure portfolios are consistent with customer objectives;
- Ensure KYC information is collected in a structured and methodical manner; and
- Ensure you have a full understanding of where and how customers want their money invested.

TCC has a great deal of experience advising on and dealing with the consequences of past suitability issues and we have found that whether suitability problems are due to inadequate systems and controls or poor training, it is always compounded by conflicting cultures and business models.
Conflicts of Interest

Conflicts of Interest is another issue that has been reviewed by the FCA almost a year into RDR, with the industry found lacking. Firms must be able to identify and manage conflicts of interest and mitigate any potential detriment to the consumer.

Where a firm’s in-house products, or products manufactured by an associated company are held within a client portfolio, the firm should question whether this is right for the consumer and ensure they can evidence that they are suitable.

Oversight

Firms should consider whether their oversight arrangements are suitable for the nature, size and complexity of their business.

Systems and controls are key, and should be sufficient to monitor and analyse the firm’s business and mitigate any risks identified.

There are numerous examples of costly enforcement action being taken against firms and individuals for failure to implement effective systems and controls. This is the cornerstone of any regulatory intervention and so it is imperative that you get this right.

TCC’S FSF CONDUCT ASSESSMENT

The FCA’s new approach to supervision is unchartered territory for the industry and so preparing for it can be uncertain and challenging. TCC has developed a comprehensive understanding of the FCA’s FSF process and the requirements for implementing effective governance, risk and control. Our expert consultants are adept at carrying out conduct risk assessments and recommending remedial action throughout the five areas the FSF will assess: Governance, Risk and Culture, Business Model and Strategy Analysis, Product Design & Development, Sales Process Analysis and Post Sales Transaction Review.

More information about TCC’s FSF Conduct Assessment can be found on our website.