



The FCA's Approach to Supervision for C4 firms

March 2014

Financial Conduct Authority



Contents

Summary of conduct supervision activity for C4 firms	4
Introduction	5
Our ten supervision principles	8
The conduct supervision categories	10
Supervising what matters	11
How our new approach affects you	14
Our three-pillar supervision model	
Our interaction with you	
Our three-pillar model in detail	16
Pillar 1: Proactive firm supervision	
Pillar 2: Event-driven, reactive supervision	
Pillar 3: Issues and products supervision	
Prudential supervision	23

Summary of conduct supervision activity for C4 firms

This page provides a high-level summary of the interaction you will have with the FCA through our conduct supervision work. Full details are in the rest of the guide, with prudential supervision covered in the final section.

The supervisory regime for many C4 firms is similar to the previous regime under the FSA in terms of the intensity and type of supervision. However, we are now looking at the culture and practices of each firm to ensure you consider consumers and market integrity in everything you do.

Ongoing supervision by **sectoral analysis and thematic reviews**.

Regular baseline monitoring of regulatory returns.

Occasional routine tasks, such as transfers, acquisitions and permission changes.

Four-yearly assessment via a phone or face-to-face interview, an online assessment, or a combination of these.

We will do further firm-specific work where risks need to be addressed.

We will also follow up with a random sample of firms that have completed the online assessment, to verify the information provided.

Introduction by Clive Adamson – Director of Supervision



This guide looks at the Financial Conduct Authority's new supervision model, and how it works in practice for you. As a firm in the **C4** conduct category you will be supervised through a sector-based approach, complemented by firm-specific engagement. We will also interact with the Prudential Regulation Authority where appropriate.

This document brings together previously published information about our model, providing a summary of the supervision activity you will experience and expanding on the details in certain areas. It does not give a step-by-step guide to every aspect of supervision, as this will vary by firm and sector. It does, however, explain the reasoning behind our approach – what matters to us – so that you can consider what this means for your business.

We outlined the principal features of our new model in *Journey to the FCA*¹ (October 2012), in the letter we sent to you in March 2013, and in *The FCA's approach to advancing its objectives*² (July 2013). We aim to adapt to the different sizes and complexities of the firms we cover, and concentrate our resources on the greatest potential risks to our objectives. To achieve this, we have divided our supervision work into three pillars of activity, supported by detailed sector analysis.

Our objectives

The FCA has an overarching strategic objective to ensure that the relevant markets function well. This is embodied in our three operational objectives:

- to secure an appropriate degree of protection for consumers

1 www.fca.org.uk/static/documents/fsa-journey-to-the-fca.pdf

2 www.fca.org.uk/static/documents/fca-approach-advancing-objectives.pdf

- to protect and enhance the integrity of the UK financial system
- to promote effective competition in the interests of consumers

These objectives are the foundation for our approach to supervision. In our relationship with you we want to ensure that fair treatment of consumers is at the heart of your business, and that you do not adversely affect market integrity and competition.

Working together

As a regulator we have to strike a balance in how we supervise the financial services industry, allowing it to grow and prosper while ensuring integrity and fair treatment for consumers. We are committed to a more open and transparent approach, where we listen to what you tell us, communicate clearly to you, and work together to identify and solve problems before they can cause damage.

We have also revised our approach to wholesale matters. In the past this has been based on the parties involved in wholesale transactions being sophisticated enough to look after their own interests. However, we have seen that this sophistication does not prevent poor behaviours from undermining market integrity, sometimes across borders, as in the case of LIBOR manipulation. Wholesale and retail markets are not isolated from each other, and costs and risks can be passed on to retail customers.

We want to ensure that fair treatment of consumers is at the heart of your business

The financial services industry is continually changing. We reflect its global nature through relationships with overseas regulators and attending international colleges, and we will adapt our approach to take account of developing trends and products as well as influencing and reacting to domestic and international legislation. For example, the Banking Reform Act (2013) made a number of changes to financial regulation, particularly in relation to accountability for senior individuals. We will reflect these in our supervisory approach and consult in a number of areas in 2014. We will also take over the regulation of consumer credit from the Office of Fair Trading in 2014.

Following the financial crisis it became clear that there were issues with culture and business practices in many areas of the financial services industry. However, we have seen a number of firms make changes to protect consumers and markets better, and we believe our new approach can help the whole industry continue this evolution. All of us must work together to rebuild trust in financial services and provide a stable and fair future for firms and consumers alike.

**We are committed
to a more open and
transparent approach**

Our ten supervision principles

Our new approach to supervision is built on these ten principles, which form the basis of our interaction with firms of all categories:

- **Ensuring fair outcomes for consumers and markets.** This is the dual consideration that runs through all our work; we will assess issues according to their impact on both consumers and market integrity.
- Being **forward-looking and pre-emptive**, identifying potential risks and taking action before they have a serious impact.
- Being **focused on the big issues and causes of problems**. We will concentrate our resources on issues that have a significant impact on our objectives.
- Taking a **judgement-based approach**, with the emphasis on achieving the right outcomes.
- **Ensuring firms act in the right spirit**, which means they consider the impact of their actions on consumers and markets rather than just complying with the letter of the law.
- Examining **business models and culture**, and the impact they have on consumer and market outcomes. We are interested in how a firm makes its money, as this can drive many potential risks.
- **An emphasis on individual accountability**, ensuring senior management understand that they are personally responsible for their actions – and that we will hold them to account when things go wrong.
- Being **robust when things go wrong**, making sure that problems are fixed, consumers are protected and compensated, and poor behaviour is rectified along with its root causes.

- **Communicating openly** with industry, firms and consumers to gain a deeper understanding of the issues they face.
- **Having a joined-up approach**, making sure firms get consistent messages from the FCA. We will also engage with the Prudential Regulation Authority to ensure effective independent supervision of dual-regulated firms, and work with other regulatory and advisory bodies including the Financial Ombudsman Service, Financial Services Compensation Scheme, Money Advice Service and international regulators.

The conduct supervision categories

We have assigned every firm to one of four categories of conduct supervision: **C1**, **C2**, **C3** and **C4**. These broadly reflect a firm's size and retail customer numbers or wholesale presence, and the corresponding level of risk the firm potentially poses to our objectives. Each category is subject to a different level of supervision, allowing us to use our resources as efficiently as possible and concentrate on the areas that pose the greatest risks to our objectives.

C1 – Groups with the largest number of retail customers, and wholesale firms with the most significant market presence. They have a named supervisor and a high level of firm-specific supervision.

This currently covers 11 major groups.

C2 – Firms and groups with large retail customer numbers and wholesale firms with a significant market presence. They have a named supervisor and a high level of firm-specific supervision.

This currently covers around 120 groups.

C3 – Retail and wholesale firms with a medium-sized customer base. They are supervised with a sector-based approach, with less frequent firm-specific engagement.

This currently covers around 400 firms and groups.

C4 – Retail and wholesale firms with a small number of customers. They are supervised with a sector-based approach, with less frequent firm-specific engagement.

This currently covers around 25,000 firms.

There are also **four prudential supervision categories**. These are independent of the conduct categories: a firm can fit into any of the prudential categories regardless of what conduct category they are in. These are explained in the Prudential supervision section at the end of this guide.

Supervising what matters

We aim to protect consumers and ensure market integrity by examining the areas that have an impact on them. This means looking at far more than systems and controls and compliance with the rulebooks. We will examine different parts of a business much more closely, and be in direct contact with a wider range of people in many firms.

We want to know how your business is really run, rather than just how you control your risks, to find where problems flow from and address them at the source. We are interested in your financial health and how you aim to make money, both now and in the future, and how your culture and strategies support fairness for consumers and markets. We will examine the risks your business poses to our objectives in these areas, and how you respond to these risks.

We will be proactive in identifying potential risks to consumers or market integrity

Our new model supports the promotion of effective competition in the interests of consumers. Sector analysis can indicate whether competition is working well in different markets, and helps guide the steps we take to promote competition. If we find firms, groups, products or behaviours that could have an adverse effect on competition, we will consider the most appropriate action to take.

We will examine the following areas to see how you put the integrity of the market and the fair treatment of consumers at the heart of how you do business:

Business model and strategy

Culture

Front line business processes

Systems and controls

Governance

Business model and strategy

We want firms to be commercially successful. However, this should not come at the expense of customers getting products and services that meet their needs, from firms they have genuine reason to trust. We

will be proactive in identifying potential risks to consumers or market integrity. To do this, we will need to understand your business model and how you make your money.

We have seen in the past that certain aspects of some strategies, such as aggressive growth targets or over-reliance on cross-subsidisation, can drive behaviours that lead to poor customer and often poor market outcomes. We will ask about the detail of your strategies and business plans, and expect you to be able to show us how you assess and mitigate the risks these generate.

Culture

We are putting a particular emphasis on understanding the culture within a firm: the way you conduct your business, what you expect of your staff, your attitude towards your customers. Your culture underpins everything you do, setting the tone for the behaviours you promote and reward.

Your culture underpins everything you do, setting the tone for the behaviours you promote and reward

You must decide what type of culture is suitable for your firm, and demonstrate it from the top down. An effective culture will ensure that you treat customers fairly in everything you do, and that you do not abuse the market you operate in.

Front line business processes

Your business processes, from product development to complaints handling, should be designed to give customers what they need and meet their expectations. We will examine retail and wholesale practices, concentrating on areas where we see the greatest risks to market integrity, consumers and effective competition.

Examples of good practice include:

- understanding and catering for the customers that a product is targeted at
- considering at the development stage how a product will achieve good outcomes for consumers

- taking account of customer experience to refine business practices
- ensuring pay structures and incentive schemes do not encourage behaviours that cause poor outcomes for consumers
- taking measures to prevent conflicts of interest

Systems and controls

You can reinforce the right culture and business practices with effective systems and controls designed to identify and deal with conduct risks, as well as effective anti-money laundering measures. We expect these to be proportionate to the size of your firm, and that they ensure customers are treated fairly.

Governance

The people responsible for running your firm have a key role to play in determining its business model, strategy and business practices, and ensuring appropriate systems and controls are in place. They should be able to explain clearly the conduct risks in your strategies, and we will pay close attention to the way they implement consumer and market-focused values. For example, we will look at how they examine issues like high-return products or business lines, whether they understand strategies for cross-selling products, how fast growth is achieved, and whether products are being sold to customers and markets that they were designed for.

An effective culture will ensure that you treat customers fairly in everything you do

The same principles for everyone

The theme running through all these areas is the focus on consumer outcomes and market integrity. We will consistently apply this in all our dealings with every firm, no matter how big or small, and whether you are active in retail or wholesale markets. You will see this new emphasis in our sector-based work as well as your firm-specific assessments.

How our new approach affects you

Our three-pillar supervision model

Our supervision work is based around three pillars of activity, which draw on our ongoing analysis of each industry sector and the risks within them. Our issues and products work and our response to specific events feed in to our proactive work with you, and every piece of work adds to and

Every piece of work adds to and enhances our views of a sector and the firms within it

enhances our view of a sector and the firms within it. This cumulative approach allows us to design our supervision strategies to the best effect.

Pillar 1 – Proactive firm supervision

We will engage with you to assess whether you have the interests of your customers and the integrity of the market at the heart of your business. We take a forward-looking approach and use our judgement to address issues that could lead to damage to consumers or markets, with clear personal accountability for your senior management.

Pillar 2 – Event-driven, reactive supervision

When we become aware of significant risks to consumers or markets, or when damage has already been done, we will respond swiftly and robustly. We will ensure you mitigate risks, prevent further damage and address the root causes of problems. If necessary, we will use our formal powers to hold the firm and individuals to account and gain redress for those who have been treated unfairly.

Pillar 3 – Issues and products supervision

We look at each sector as a whole to analyse current events and investigate potential drivers of poor outcomes for consumers and markets. We do this on an ongoing basis, so we can address risks common to more than

one firm or sector before they can cause widespread damage. These could be issues like a trend for a particular business practice, or a problem with a certain product.

Our interaction with firms

Our Supervision Division is structured around specialist departments for each industry sector, applying the three-pillar approach appropriately with the right expertise. As a general principle, we want to promote good conduct standards across whole sectors rather than solely on a firm-by-firm basis. Accordingly, there will be an increase in sector-based work such as thematic reviews, where we use our findings to address issues and drive improvements across the sector.

Your routine point of contact is our Firm Contact Centre. Contact Centre staff have the expertise to deal with most issues and queries, and pass them on to the appropriate FCA specialists when necessary.

You will have an individual assessment at least once every four years, but most of the supervision you will see is likely to be sector-based. This will be a change for some firms that have been used to closer, dedicated supervision.

We will give you feedback after your assessments and work with you directly when dealing with particular events. After thematic work we will issue feedback on a sector-wide or firm-specific basis as appropriate. This helps you to continually address your risks and conduct issues, with a general expectation that you will act to fix problems yourselves.

Our three-pillar model in detail

Pillar 1: Proactive firm supervision

Pillar 1 deals with our assessment of firms, and how we address potential risks. We will consider this fundamental question in every aspect of our proactive supervision:

Do you have the interests of your customers and the integrity of the market at the heart of how you run your business?

We assess your firm individually every

four years to understand how you run your business, and the impact this has on consumers and markets. We want to see how you identify risks and what you do to mitigate them. For many firms the way we carry out these assessments will be similar to what you are used to, but for around a quarter of the firms we supervise it will be a new experience.

Most C4 firms are **retail intermediary firms**. For this group we divide the UK into 12 geographic regions, and assess firms in three regions each year.

This work is split into three phases:

- 1 All firms in a region are invited to a workshop designed to help you identify risks in your business that affect the FCA's objectives.
- 2 Following the workshop, we assess each firm to understand key areas such as risks in your business model, how these are managed and how customers are affected by them. The review will be done by a phone or face-to-face interview or through our online tool. The format will depend on the risk we think your firm poses to our objectives. The content is the same regardless of which way the review is conducted, and you will be given immediate feedback. If you have a face-to-face

Proactive firm supervision: key features

- Four-yearly assessment
- Regional workshops to help you identify risks
- Online, phone or face-to-face review of your firm

review this will happen at the interview. If you use the online tool you will receive an instant response by email, containing the tool's automatic analysis of the information you have provided.

- 3** If we find that your firm carries significant risks we will do further work, which may include visiting you, to better understand the risks and how they are being mitigated. You will be given detailed feedback about any actions we require you to take.

We will follow up a random sample of assessments with the firms to verify the information provided. This could involve a visit to a firm or a request for documents to be sent to us for review. These firms will be provided with written feedback.

We will assess other firms with sector-specific variations of this approach. If this applies to you, we will contact you in advance of your assessment with the relevant details.

Pillar 2: Event-driven, reactive supervision

Our new approach to supervision has a pre-emptive focus, aiming to identify and prevent consumer detriment and threats to market integrity before they happen. However, when things go wrong we will take quick and robust action, including securing redress for consumers. We prefer to work with firms voluntarily, but will enforce our decisions if necessary.

We can discover risks or problems through a number of sources, including information from the firm as well as data analysis, whistleblowers and consumer complaints. You have a duty to tell us about any risks or problems that emerge that might have an impact on our objectives, such as consumer detriment.

Event-driven, reactive supervision: key features

- We will respond quickly and robustly when things go wrong
- Our responses will be proportionate to the problems
- We will focus on the most important issues affecting our objectives
- We expect you to have comprehensive and credible plans of action to mitigate risks

Our response to an event will depend on the nature and size of the problem. We have a large range of tools available, including formal powers such as skilled persons reports. Where we are aware the same risk is evident in more than one firm, we can engage with the industry as a whole to ensure all firms mitigate the risk, consumers are protected and poor behaviour is rectified.

We will expect you as a firm to fix the root causes of problems as well as the symptoms.

Our focus is on addressing the most important issues that affect our objectives. We will expect you as a firm to fix the root causes of problems as well as the symptoms. Instead of using our resources to carry out extensive follow-up work, we will expect you to have a comprehensive and credible plan of action to mitigate risks. In some cases you will have to formally attest that risks have been addressed and demonstrate that appropriate outcomes have been achieved.

If issues arise that mean you are no longer meeting your threshold conditions³, we will respond accordingly.

Baseline monitoring and other supervision tasks

Baseline monitoring involves reviewing the regulatory data you submit. This is a vital source of information which allows us to detect risks, including the financial drivers that may result in firms behaving in ways that harm consumers and markets.

We also deal with a variety of other supervisory work that firms may generate from time to time, such as Part VII transfers, acquisitions or permission changes.

³ <http://fshandbook.info/FS/html/FCA/COND>

Supervision in action

Reactive supervision

Mis-selling in-house products

A whistleblower alleged that a firm's advisers were systematically replacing customers' existing investments regardless of their suitability. Our review confirmed that unsuitable replacements had been made, and the firm's centralised investment proposition was skewed in favour of in-house solutions.

We considered the potential root causes of the mis-selling and how the replacement business was driven by the business model and culture within the firm. We focused on economic drivers and found that, while the firm was loss making, the return to the group through selling the in-house model portfolios was a key source of group profit. Through interviewing advisers and analysing training records, we discovered that there was an attitude within the firm that the in-house product was inherently superior to any other solution, and this culture had been embedded through senior management communications and the firm's training programme. We also analysed the firm's financial incentives for advisers and found they were likely to increase the risk of mis-selling.

As a result of our interventions the firm restructured its business model to remove the bias against external low-cost solutions. It also underwent a fundamental cultural change which was driven at group level. There were a number of positive changes to the firm's practices, including: adviser training focusing on achieving the right solution for the customer; the introduction of a robust replacement business policy with an enhanced control framework; and financial incentives being geared to quality of advice rather than sales activity.

Pillar 3: Issues and products supervision

This work is based around our thematic reviews, where we examine emerging risks, new products and other issues that are common to multiple firms or sectors. We identify these through our analysis of each sector and ongoing proactive supervision work. This is a key element of our forward-looking and pre-emptive approach.

Where we find a significant risk, we will do thematic work with a number of firms to assess the issues and respond appropriately. We will address our responses to the industry at large, and expect you to consider and act as necessary on our findings. You may see more of this kind of guidance than in the past.

We will also carry out studies to analyse the effectiveness of competition in different markets, and identify areas where we can intervene to promote more effective competition. This is an important tool in improving financial services for consumers.

Thematic and competition work is designed to address root causes of risks to consumers and market integrity exhibited by multiple firms, and the structural and behavioural barriers to competition working in consumers' interests.

Thematic work focuses on achieving sector-wide outcomes, and mitigating risks, rather than on providing guidance to individual firms. Recent examples include work on outsourcing in asset management, governance of unit-linked funds, mobile banking, price comparison websites, and the implementation of the Retail Distribution Review.

We will place greater emphasis on understanding customers' experience, and will use tools such as consumer research or market surveys to support our work. We will also have a stronger behavioural economics focus, looking at how customers interact with products, services and firms in practice.

Issues and products supervision: key features

- Centred around thematic reviews
- Our focus is on achieving sector-wide outcomes
- Greater emphasis on understanding customers' experiences

Assessing multiple firms in this way allows peer comparison and a more nuanced, specialist analysis of the drivers of risks. We will adapt our work to take account of different business models or multiple issues. This ensures that we make consistent assessments and take proportionate action against individual firms, tailored to fit the priority of the risk and the resources available to mitigate it.

We will be more transparent about the areas we are interested in and why, and will engage with the industry at a much earlier stage when we examine issues and products. If you are likely to be affected you can then start considering what it means for you, and take early action ahead of our formal conclusions.

When we decide that action is needed to reduce a risk to consumers or market integrity, we will address our response to all firms in the relevant market, not just those that have been involved in the assessment work. Our responses could include guidance to the industry, policy changes or consumer communications. We will generally publish the results of our thematic work, and use it to highlight good practices as well as areas of concern. In this way, we can address issues and drive improvements across the industry rather than concentrating on individual firms.

Thematic work focuses on achieving sector-wide outcomes, and mitigating risks, rather than on providing guidance to individual firms.

Supervision in action

Issues and products supervision

Interest-only mortgages

We took pre-emptive action to mitigate an impending risk for mortgage lenders and customers. Approximately 2.6m interest-only residential mortgages are due to mature over the next 30 years, with 594,000 maturing by 2020. Our research found that 10% of customers did not have a plan to repay the capital and up to 50% were facing a shortfall, often a significant one, if they take no further action.

We focused on the borrowers who are potentially most at risk – those who need to repay by 2020. We prompted lenders to write to these customers, encouraging them to check their repayment plans. Firms have responded positively and are already engaging with their customers in this way.

Alongside this, and following industry consultation, we published guidance in August 2013 setting out what we expect firms to do to ensure they treat customers with maturing interest-only mortgages fairly. We require lenders to engage early and effectively with customers to prompt them to take action to minimise the risk of non-payment at the end of the mortgage term. They should also ensure customers are offered appropriate options and are given enough time to consider them, and that staff are trained to ensure fair customer outcomes.

This was a forward-looking piece of work to minimise the impact of future problems. Our findings and key messages were widely publicised in over 100 media articles, television and radio broadcasts.

Prudential supervision

The FCA is the prudential supervisor for most firms across the financial services industry, such as asset managers, independent financial advisers, and mortgage and insurance brokers.

Our approach aims to minimise the harm to consumers, wholesale market participants and market stability when firms experience financial stress or fail in a disorderly manner. Our starting principle, however, is that if firms are failing they should be allowed to in an orderly manner.

Prudential supervision: key features

- We aim to minimise damage when firms experience financial stress
- We will allow firms to fail in an orderly manner
- Firms are grouped into prudential categories which determine their level of prudential supervision

Prudential categories

Firms that are prudentially regulated by the FCA fall into four prudential categories: **P1**, **P2**, **P3** and **P4**. These categories reflect the impact that the disorderly failure of a firm could have on markets and consumers.

Our prudential categorisation takes account of:

- size
- trading activity
- key or dominant positions as intermediary or provider
- the impact a firm's failure would have on its customers and the markets it operates in
- significant holdings of client money or assets
- other relevant considerations

P1 firms and groups are those whose failure could cause significant, lasting damage to the marketplace, consumers and client assets, due to their size and market impact.

P2 firms and groups are those whose failure would have less impact than P1 firms, but would nevertheless damage markets or consumers and client assets.

P3 firms and groups are those whose failure, even if disorderly, is unlikely to have a significant market impact. They have the lowest intensity of prudential supervision. Almost all C4 firms fall into the P3 prudential category.

P4 firms are those with special circumstances – for example, firms in administration – for which bespoke arrangements may be necessary.

Like the conduct categories, the prudential categories determine the intensity of our prudential supervision for each firm.

Through our prudential activities we ensure that:

- you maintain adequate financial resources in line with legal requirements
- we have early warning of financial issues that could drive behaviours that endanger your compliance with conduct, financial crime, client assets and other core regulatory standards
- any wind-down of a firm could happen with little or no damage to markets and consumers

Prudential risk analysis

For **P1 and P2 firms**, we carry out comprehensive capital and liquidity analysis and assess your risk management capability. When we do see the signs of financial distress in any of these firms, we will form a crisis management group to assess all realistic actions and options.

For **P3 firms** we do not typically carry out prudential assessments, or proactively review or challenge how you calculate and meet your financial resources requirements. We monitor P3 firms in two ways:

- reactively, through an alerts-based system that enables us to identify and deal with firms that have breached their prudential regulatory requirements
- through targeted cross-firm work assessing if firms in a peer group are meeting their financial resources requirements

Financial Conduct Authority



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