How the FCA will supervise firms

The FCA will be the conduct supervisor for approximately 26,000 firms across all industry sectors and the prudential supervisor for approximately 23,000 firms not regulated by the PRA.

Our new approach is designed to support a judgement based and pre-emptive approach that is focused on delivering the FCA’s statutory objectives. The model involves building our supervision around three clear pillars, each of which has a distinct purpose and explained in further detail below.

We will have supervisors conducting in-depth and structured supervision work on those firms with the greatest potential to cause risks to consumers or market integrity. This will mean that some 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.

Pillar 1. Proactive Firm Supervision (Firm Systematic Framework) – the purpose of the Firm Systematic Framework is to assess whether the firm is being run, currently and prospectively, in a way that results in the fair treatment of customers, minimises risks to market integrity, and does not impede effective competition. The aim is to identify and mitigate the key drivers of poor conduct behaviours and to ensure that firms behave in a way that minimises the risk they represent to our objectives both now and in the future. This is carried out through a firm specific assessment, answering the question “does the firm have the interests of its customers and the integrity of the market at the heart of how the business is run?” and may result in a programme of action required of the firm.

Pillar 2. Event-driven work – the purpose of event-driven supervision is to deal with issues that are emerging or have happened and are unforeseen in their nature. These could be issues that are crystallising or have crystallised, and where we may be seeking redress. Event-driven issues are frequently of high importance and our handling is critical to avoid the problem crystallising or, if it has crystallised, getting worse. For all cases, we will act faster and more decisively than before.

Pillar 3. Issues and products – the purpose of issues and products work, or thematic supervision, is to allow the FCA to address our key conduct priorities at the issue and product level. Issues and products work is driven by sector risk assessments of what is currently and prospectively driving poor outcomes for consumers and market participants, drawing on data analysis, market intelligence and input from the firm assessment process. The FCA’s product intervention powers reinforce the effectiveness of the approach by allowing us to intervene early to mitigate and remedy emerging risks before they cause widespread detriment across a sector. The 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.

Prudential Approach - the FCA’s prudential supervision approach focuses on minimising the impact of failure on consumers and market participants, with pro-active supervision limited to a relatively small number of ‘prudentially critical’ firms. A prudential firm
classification (P1–P4) drives the intensity of prudential supervision. More information on what it means to be P1–P4 firm can be found on pages 3 and 4.

**Conduct Classification and what this means for how a firm will be supervised**

The conduct classification is based on a combination of:

- impact metrics: a measure of a firm’s potential impact on FCA objectives, using data accumulated by the FSA; and
- the number of retail customers a firm has.

**C1 and C2 Firms** - will be classed as ‘fixed portfolio’, which means they will have a dedicated supervisor.

The model for C1 and C2 firms involves a threefold approach:

- A Business Model and Strategy Analysis (BMSA) that aims to identify the conduct risks that may be inherent in the business model of the firm using a ‘follow the money’ approach;
- Proactive supervisory engagement with C1 and C2 firms through meetings with senior management, management information and analysis of emerging risks; and
- Deep dives into certain areas where we need more in depth work undertaken – these could for example be on a firm’s product governance or sales processes.

**C1 Firms**

For C1 firms, proactive supervision will be on a 1 year cycle. A C1 firm should expect 2 deep dives during this period. At the end of each 1 year cycle the firm will receive a letter, setting out the FCA view of the firm and the risks it poses to our objectives. This letter will also include the supervision work programme for the next period as well as any actions we will expect the firm to take to address underlying root causes and remedy particular deficiencies (Risk Mitigation Programme).

**C2 Firms**

For C2 firms proactive supervision will be on a 2 year cycle. A C2 firm should expect 2 deep dives during this period. At the end of each 2 year cycle the firm will receive a letter, setting out the FCA view of the firm and the risks it poses to the FCA objectives. This letter will also include the supervision work programme for the next period as well as any actions we will expect the firm to take to address underlying root causes and remedy particular deficiencies (Risk Mitigation Programme).

**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.

We 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, we 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. A C4 firm will be subject to a ‘touch point’ once during a 4 year cycle to determine how it runs its business, but this will be a lighter assessment than for C3s. This could range from a roadshow, an interview, a telephone call, an online assessment, or a combination of these. The exact interaction will depend on our assessment of the risk such firms pose to our objectives.

We will want to see how firms identify and take action to reduce risks to their business. Only those C4 firms deemed to pose a sufficiently high risk to our objectives will be the subject of further firm-specific proactive work.

Firms in any conduct category may be included in Issues and Products work.

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**Next Steps for C1-C3 firms**

Firms will be moved onto the new Firm Systematic Framework processes on a phased basis from May 2013 until December 2013. We will write again in April to all firms/groups that have a dedicated supervisor to confirm the details of who their supervisor will be and, if they have changed to no longer having a dedicated supervisor, what this means for them in more detail. Where applicable we will also confirm your programme of work (RMPs) and if appropriate, any changes to this. We will also tell you when your firm can expect to move on to the new Firm Systematic Framework process, if applicable.

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**Prudential classification and what this means for how a firm will be supervised**

For those firms where the FCA is their prudential regulator, prudential analysis and monitoring are part of the overall supervision approach, and inform targeted supervisory work where financial and prudential risks could make firms vulnerable to behaviour that harms consumers, damages market integrity or otherwise poses risks to the FCA’s statutory objectives. Financial and prudential analysis also takes into consideration potential contagion effects – from a legal entity to other members of a group, or from a firm to the remainder of its sector.

The prudential classification is based on an analysis of data provided by firms in their regulatory returns. Additional information and data is reviewed where regulatory returns do not provide a complete picture of a firm’s complexity or potential market impact.

**P1 Firms**

Firms will be categorised as P1 if they are prudentially critical and their disorderly failure would have a significant impact on the market in which they operate (for example, because a particular market is highly concentrated, so that a disorderly failure of one player could not easily be assimilated by the others and/or where there are significant client asset and money holdings).
**P2 Firms**
Firms will be categorised as P2 if they are prudentially significant firms and their disorderly failure would have a significant impact on the functioning of the market in which they operate, but there is a smaller client asset and money base or an orderly wind-down can be achieved.

Broadly, groups classed as P1 or P2 can expect a periodic assessment of their capital (and, if applicable, liquidity) requirements and how well they meet our broader prudential expectations, some of which may be encapsulated in Risk Mitigation Programme. This may entail prudential focused firm visits.

**P3 Firms**
Firms will be categorised as P3 if they are prudentially non-significant and their failure, even if disorderly, is unlikely to have significant impact. We will be relying more on firms’ own assessment of their financial resource requirements and focus on monitoring alerts that arise from inconsistencies and/or prudential failings. P3 firms may also be subject from time to time to a prudential assessment by the FCA as part of a peer group exercise, i.e. a cross-firm review of capital and liquidity standards.

**P4 firms**
These are firms which due to their specific nature or circumstances require a differentiated approach to prudential supervision. This can include firms in administration / insolvency or entities with special supervisory regimes.

The conduct and prudential classifications are developed to reflect the way different aspects of a firm’s operations can potentially impact the FCA’s objectives, and therefore it is possible for a firm to be significant from a conduct perspective but less so prudentially, and vice-versa.

**Applicability to groups**
The FCA prudentially classifies any group with FCA solo regulated entities. This includes a group with only FCA solo regulated entities or one that also contains PRA dual regulated entities. The FCA does not, however, prudentially classify a group with only PRA dual regulated entities.

In the case of a group of firms, the FCA solo regulated entity potentially representing the largest impact to the FCA’s prudential objectives will drive the group’s notional prudential categorisation. Each entity within a group will initially share the group-wide categorisation. This does not mean, however, that each FCA solo entity within a group will be supervised by the FCA with the same degree of intensity.

There are some different permutations where groups of firms have FCA and PRA-regulated entities within them, as shown in the table below.

<table>
<thead>
<tr>
<th>Group with only FCA solo regulated entities</th>
<th>FCA has responsibility for prudential supervision for the group and solo entities.</th>
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</thead>
<tbody>
<tr>
<td>Group led or managed by an FCA solo regulated entity,</td>
<td>The FCA and PRA coordinate group supervision responsibilities. The FCA is responsible for the</td>
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with one or more PRA dual regulated entities. | supervision of all FCA solo firms and group activities.  

*Note – there are a range of interactions between the FCA and PRA which can occur in such a group, depending on the group’s structure and the application of EU Directives*

| FCA solo entities in group lead or managed by a PRA dual regulated entity | The FCA and PRA coordinate group supervision responsibilities. The FCA remains accountable for all FCA solo regulated firms.  

*Note – there are a range of interactions between the FCA and PRA which can occur in such a group, depending on the group’s structure and the application of EU Directives*

| Group where all regulated entities are PRA dual supervised. | PRA has responsibility for prudential supervision for the group and all regulated entities.  

*Note – the addition of a new entity which is FCA solo regulated in the group would trigger an FCA prudential classification to be applied.*

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**Approach to branches**

The FCA supervises a range of both EEA and non-EEA branches. Branches may be treated for the purposes of prudential classification as part of a larger group of firms, or if they are managerially and operationally separate from other UK based regulated activity of the group, they may receive their own classification. Currently for administrative purposes all branches will be classified P1-4, however this does not affect the legal status, permissions or FCA remit over any branch. For EEA branches the FCA will follow Directive requirements, placing reliance on Home State Supervisors as required, or undertaking appropriate prudential supervision as required (for example, liquidity for ILAS branches). For non-EEA branches, supervision will be performed on the basis of the branch’s UK permissions and following any formal agreements made with the branch’s home country regulator(s).