

John Griffith-Jones
Chairman of the Financial Conduct Authority
Financial Conduct Authority
25 The North Colonnade, Canary Wharf, London, E14

October 8th, 2015

Subject: Strengthening the FCA's 2nd Line – Assurance Letter

Dear Chairman,

The purpose of this letter is to summarise Oliver Wyman's opinion in response to the request by the Board of the FCA to review whether or not the FCA's 2nd line of defence is suitable for an institution of its role and remit.

Summary Terms of Reference

Oliver Wyman was appointed to review the FCA's risk framework document and the role of the Risk and Compliance Oversight Division (R&CO) to provide assurance, subject to the identified enhancements, on their suitability given the role and remit of the FCA. [see appendix A for TORs]

The assessment was conducted relative to a broad peer set that could reasonably constitute a set of compelling best practices.

Process

Oliver Wyman worked with the FCA from June 20th to September 4th 2015. The work was led by a Partner team with extensive Risk and Regulatory experience, supported by a dedicated consultant team consisting of a Principal, Engagement Manager and Senior Consultant. The FCA assembled two groups of individuals a) a Steering Committee composed of John Griffith Jones, Sir Brian Pomeroy, Richard Sutcliffe, and David Godfrey to review emerging findings and recommendations and b) a working group comprised of R&CO representatives from the FCA to provide the Oliver Wyman team with necessary information. The assessment of the FCA's current state was based on available documentation (over 40 documents) and discussions with eight senior stakeholders and subject matter experts [see appendix B for list of FCA interviewees]. Oliver Wyman met weekly with the Working Group to gather information on the current state. All evidence was presented and debated at four workshops with a broad set of senior R&CO representatives from the FCA. Interim conclusions were presented at a Steering Committee on July 23rd, 2015. Final results including recommendations and implementation plans were presented to the Steering Committee on September 10th, 2015. Recommendations agreed by the Steering Committee were discussed with the FCA Executive Committee and presented to the FCA Board on September 24th, 2015.

Methodology

Our assessment is based on a comparison of the FCA to a composite best practice comprising the best capabilities observed across other UK regulators, a handful of advanced conduct-of-business regulators in other jurisdictions and development finance institutions. The work produced four main deliverables:

1. Definition of a comprehensive reference framework to test the adequacy of objectives, governance, organisation, functional responsibilities and infrastructure of 2nd line activities within a three lines of defence construct:
 - a. First line: Own and Manage risk: In charge of day to day operations; identifies, assesses, controls, mitigates, and is accountable for risks, implementing frameworks and policies set by the 2nd LOD
 - b. Second line: Oversee risk: Guidance and oversight function that defines the organisation-wide risk framework, policies and guidelines and ensures that risks are managed comprehensively and effectively by the 1st LOD within those boundaries
 - c. Third line: Provide independent assurance: Independent assurance function evaluating the organisation's risk framework, risk management, internal controls and the effectiveness of the interaction between 1st LOD and 2nd LOD
2. A review of the FCA's "current state" 2nd LOD with respect to the framework, distinguishing between:
 - a. Current practices
 - b. In-flight initiatives and enhancements (designed, but implementation not completed)
3. An articulation of composite best practice with respect to the framework based on Oliver Wyman's understanding of peer practices
4. Identification of gaps relative to best practice, and recommended enhancements to the FCA to close said gaps with high-level implementation plans

Summary conclusions

R&CO was formally designated as the second line of defence in December 2014 following the merger of the pre-existing second line departments (Risk and Supervisory Oversight Function), the appointment of a Director and increased clarity of roles and responsibilities across the 2nd LOD.

Based on our assessment, we consider the FCA to compare favourably to the average of UK regulators and highlight four main attributes of FCA's approach to 2nd line risk management that are good practices relative to other UK regulators:

- 1) Comprehensive risk framework for identification and measurement of regulatory risks (i.e. those risks that it has the mandate and powers to regulate) and operational risks (i.e. risks resulting from failed internal processes, people or systems)
- 2) Strong first line accountability for regulatory risk management: supervisors clearly accountable for risk identification and mitigation with respect to regulatory risks through a comprehensive risk identification and attestation process
- 3) Comprehensive risk governance model: robust risk management oversight bodies for regulatory and operational risks and formal articulation of the three lines of defence model
- 4) Enterprise-wide risk register: robust internal system to enable centralised logging and measurement of identified risks

We flag that a number of the elements of items 3&4 – particularly as they relate to operational risk – are under development as part of the planned enhancements by the R&CO division. Whereas the design of initiatives appears broadly in line with best practice, we note that implementation is not complete and is therefore subject to the uncertainty of outcomes.

Based on our work, we have identified two main recommendations for the FCA:

- 1) Strengthen risk tolerance framework to underpin organisation-wide risk management and decision making. Develop common risk and mitigation reporting framework for Board and Executive committees including systematic capture of cross-divisional risks.
- 2) Refine risk categorisation to raise the profile of the risk that the FCA assigns inappropriate mitigation strategies to regulatory risks and does not carry out assigned mitigation strategies appropriately. Ensure risk terminology and resultant hierarchy is applied consistently across all FCA activities.

Given the FCA's role and remit, successful implementation of these enhancements will deliver a suitable 2nd line capability that matches UK regulators' best practice.

One further recommendation will align the FCA to the broader composite best practice and is summarised as:

- 1) Strengthen R&CO's mandate and accountability as the formal 2nd line of defence through developing a formal approach to risk culture and compliance,

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ensuring 2nd line role in oversight of the full universe of risks and clarifying real and perceived overlaps across the three lines of defence

As outlined above, we have worked with you for 12 weeks to review the risk framework document and the role of the Risk and Compliance Oversight Division to provide assurance, subject to identified enhancements, on their suitability given the role and remit of the FCA.

Yours sincerely,



Davide Taliente
Managing Partner – Europe

Appendix A: Terms of Reference

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STATEMENT OF REQUIREMENTS

Strengthening the FCA's 2nd Line

TEN-15-045

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1. Overview of the objectives for the team procuring

The FCA undertook a strategic review throughout 2014 to consider the effectiveness of our operations two years after formation and in light of changes to our remit and scope by the introduction of Consumer Credit regulation in April 2014. The FCA Strategy was made public in December 2014 which included a number of wide ranging proposals for changes and improvements; page 7 of that document is particularly relevant to this work.

One element of this Strategy is a more strategic approach to risk through a strengthened 2nd line¹ bringing together our Risk and Supervisory Oversight departments to create the Risk and Compliance Oversight Division.

The Davis Review (December 2014) and the recent TSC Report into Briefing of the Business Plan 2014/15 have raised the external profile of the choices we now make in delivering this. We are therefore seeking Consultancy support to work with the FCA's Risk and Compliance Oversight Division to establish whether our approach to the 2nd line of defence is appropriate for a public organisation of our size and complexity and what additional activities we may need to move to best practice.

The focus of this work is the 2nd line; structure, remit and purpose. This is not a review of the 3 lines of defence approach adopted by the FCA, nor a review of 1st line risk management.

The main aims and objectives for the successful consultancy are to:

1. Work with the FCA's Risk and Compliance Oversight Division to ensure our structure and responsibilities deliver on the FCA's Strategy, and in particular its decision to strengthen the 2nd line approach.
2. Engage and work with the Risk Framework team in implementing any improvements suggested by the work under 1 above. This should include updating the Risk Framework to reflect the strengthened role of the 2nd line.
3. To review the FCA's risk framework document and the role of the Risk and Compliance Oversight Division (R&CO) to provide assurance, subject to the identified enhancements, on their suitability given the role and remit of the FCA. [It would not be appropriate to provide a view based on the approach of FCA regulated entities – we are seeking a view based on comparable UK Regulators].

¹ The FCA reserves the right to award similar or identical services to other suppliers if the work is not to be performed by the contracted supplier(s) for any reason.

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2. Overview of Requirements

The FCA is seeking a supplier that can demonstrate they have appropriate personnel who understand our cultural characteristics and have a demonstrated expertise on risk management in similar organisations. We are looking to work in partnership with the provider to ensure that we deliver on the 3 aims set out above.

The contract will be let for an initial term of 3 months, with the option to extend for up to a further 3 months to provide ongoing support through proposed developments. In this second stage we envisage monthly touch points to engage and discuss proposals. Additionally, it is not clear how many of the outcomes can be achieved in 3 months which strengthens our desire to have an option to extend.

3. Detailed Requirements/Deliverables

The areas that we wish to cover in this work include:

1. Work with the FCA's Risk and Compliance Oversight Division to ensure our structure and responsibilities deliver on the FCA's Strategy, and in particular its decision to strengthen the 2nd line approach.
 - We expect the supplier to engage with key members of the Board and Senior Leadership Team to gauge their views on the 2nd line approach. We also expect the supplier to conduct a series of day long workshops with key representatives of the Risk and Compliance Oversight Division including Senior Advisors to get input and frame recommendations.
 - *The deliverable is a presentation to the FCA's Executive Committee (including the Director of Risk Compliance and Oversight).*
2. Engage and work with the Risk Framework team in implementing any improvements suggested. This should include updating the Risk Framework to reflect the strengthened role of the 2nd line.
 - Detail any changes suggested by the work under point 1 above.
 - *The deliverable is a set of detailed recommendations (included in the presentation above) on how we can strengthen the current approach.*
3. Provide assurance that the subsequent 2nd line approach is credible and appropriate for an organisation of the complex statutory remit of the FCA. [It would not be appropriate to provide a view based on the approach of FCA regulated entities – we are seeking a view based on comparable UK Regulators].
 - Benchmarking the 2nd line against equivalent functions in organisations of similar remit focussing on regulatory activities not the firms we regulate including key components such as the risk attestation approach.

Appendix B: Complete list of interviewees

Interviewee	Division / Team
Tracey McDermott	Director, Supervision & Authorisations
David Godfrey	Director, Operations
Sean Martin	Director, GCD
Martin Wheatley	CEO
Christopher Woolard	Director, Strategy & Competition
Lalitha Henry	Director, Internal Audit
Georgina Philippou	Director, Enforcement & Mkt Oversight
Gunner Burkhart	Senior Adviser