The FCA's Approach to Supervision

for flexible portfolio firms

Financial Conduct Authority

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Summary of conduct supervision activity for flexible portfolio 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 purpose of the supervisory regime is to look at the culture and practices of firms to ensure you consider consumers and market integrity in everything you do.

Our approach in the flexible portfolio is to focus at a market level, to understand conduct on a sector or subsector basis and mitigate risks accordingly. We will engage with individual firms on a sample basis, through a variety of activities, to inform our judgements and influence how the market operates with respect to our objectives.

The work we undertake will include:

Ongoing supervision by **sectoral analysis and thematic reviews.** These range from large and detailed studies to smaller sample-based work.

Regular baseline monitoring of regulatory returns.

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

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

Communication and, where appropriate, education and engagement activity to address risks on a market level.

Introduction

This guide looks at our supervision model, and how it works in practice for you. As a flexible portfolio firm you are supervised through a sector-based approach, with firm-specific engagement determined by our risk assessment and prioritisation model. We 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 published a new strategy[1] for the FCA in December 2014, and the supervision model has subsequently been revised to implement the new approach. Broadly speaking, these revisions aim to improve the way in which we use our resources by increasing flexibility, taking a more sector-based approach to risk identification and prioritisation, and engaging more widely with market representatives. The changes that have been made have been communicated separately, and are incorporated in this guide.

1 www.fca.org.uk/static/documents/reports/fca-our-strategy-december-2014.pdf

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
- 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 an 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.

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 better protect consumers and markets, and we believe our new approach can help the whole industry continue this evolution. We must all work together to rebuild trust in financial services and provide a stable and fair future for firms and consumers alike.

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Our ten supervision principles

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

- **Ensuring fair outcomes for consumers and markets.** This is the dual consideration that runs through all of our work. We 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 concentrate our resources on issues that may 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 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 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 Payment Systems Regulator, Financial Ombudsman Service, Financial Services Compensation Scheme, Money Advice Service and international regulators.

Conduct classification: fixed portfolio and flexible portfolio firms

We previously used four categories (C1-C4) for the conduct classification of firms. In line with our revised strategy, we have simplified this approach and now differentiate firms as either fixed portfolio or flexible portfolio. It is these categories that determine the nature and intensity of our conduct supervisory approach.

Fixed portfolio firms are a small population of firms (out of the total number regulated by us) that, based on factors such as size, market presence and customer footprint, require the highest level of supervisory attention. These firms are allocated a named individual supervisor, and are proactively supervised using a firm-specific continuous assessment approach (for details, please refer to the equivalent supervisory approach document for fixed portfolio firms[2]).

The majority of firms are classified as **flexible portfolio**. As described later in this document, these firms are supervised through a combination of market based thematic work and programmes of communication, engagement and education activity aligned with the key risks identified for the sector in which the firms operate. These firms use our Customer Contact Centre as their first point of contact with us as they are not allocated a named individual supervisor.

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.

2 www.fca.org.uk/about/what/regulating/how-we-supervise-firms/our-approach-to-supervision

Supervising the areas that matter

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 businesses are really run, rather than just how they control their risks, to find where problems flow from and address them at the source. We are interested in their financial health and how they aim to make money, both now and in the future, and how their culture and strategies support fairness for consumers and markets. We examine the risks businesses pose to our objectives in these areas, and how they respond to these risks.

Our 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.

Our model supports the promotion of effective competition in the interests of consumers

We examine the following areas to see how firms put the integrity of the market and the fair treatment of consumers at the heart of how they 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 are proactive in identifying potential risks to consumers or market integrity. To do this, we need to understand firms' business model and how they make their 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 expect you to examine your strategies and business plans, to assess and mitigate the risks they 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.

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You must decide what type of culture is suitable for your firm, and demonstrate appropriate behaviours 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 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 at which a product is targeted
- 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 understand the conduct risks in your strategies, and the way they implement consumer and market-focused values. For example, how they examine issues like high-return products or business lines, whether they understand strategies for cross-selling products, how quickly growth is achieved, and whether products are being sold to customers and markets for which they were designed.

The same principles for everyone

The theme running through all these areas is the focus on consumer outcomes and market integrity. We 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.

How our 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 its risks. Every piece of work adds to and 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 do not carry out work under Pillar 1 to assess flexible portfolio firms individually, instead we take a market-based approach to assess the sector as a whole (see Pillar 3).

For the small number of fixed portfolio firms, we assess whether they have the interests of their customers and the integrity of the market at the heart of their businesses. 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 the firms' 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 respond swiftly and robustly. We ensure you mitigate risks, prevent further damage and address the root causes of problems. If necessary, we 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. This work ranges from large and detailed studies to smaller sample-based work and is our primary form of proactive work with flexible portfolio firms.

Communications and education

In addition, and to complement the three pillars above, we will engage with sectors, firms and market representatives to communicate our views, findings from work and our expectations. Where appropriate, we undertake education work to supplement this.

Our interaction with firms

Our Supervision Divisions are 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, our focus is towards sector-based work, including thematic reviews, where we use our findings to address issues and drive improvements across the sector.

Our Supervision Divisions are structured around specialist departments for each industry sector

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

We will give you direct feedback 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 yourself.

Our flexible portfolio supervision model in detail

Pillar 1: Proactive firm supervision

As described above, Pillar 1 deals with our assessment of individual firms, and how we address potential risks on a firm-by-firm basis. Due to the market-based nature of flexible portfolio supervision, we will only undertake Pillar 1 work for fixed portfolio firms.

Pillar 2: Event-driven, reactive supervision

Our 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 take quick and robust action, including securing redress for consumers. We prefer firms to work with us voluntarily, but will enforce our decisions if necessary.

Event-driven, reactive supervision: key features

- **We respond quickly and robustly when things go wrong. Our responses are 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**

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.

Our response to an event depends 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 that 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.

Our focus is on addressing the most important issues that affect our objectives

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 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 conditions[3], 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 https://www.handbook.fca.org.uk/handbook/COND/

Pillar 3: Issues and products supervision

This work is fundamental to our forward-looking and pre-emptive market-based approach to identifying and mitigating risks across multiple firms or whole sectors. Through our analysis of each sector, we identify common emerging risks, new products and other issues, which we examine through a range of activities, including thematic reviews.

Issues and products supervision: key features

- **A blend of market-based work, including thematic reviews**
- **Our focus is on achieving sector-wide outcomes**
- **Greater emphasis on understanding customers' experiences**

On the basis of our findings, we respond appropriately, which will include communicating our responses to the industry. This might be through published reports for the industry at large, or communicating more at a subsector level. You are expected to consider and act as necessary on our findings.

We 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. These are an important tool in improving financial services for consumers.

Market-based, thematic and competition work are 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.

The work focuses on achieving sector-wide outcomes and risk mitigation, rather than on providing guidance to individual firms. Recent examples include work on structured products, high-cost short-term credit, the handling of insurance claims for SMEs, governance over mortgage-lending strategies, and adviser charging.

Our emphasis is on understanding customers' experiences, and we use tools such as consumer research or market surveys to support our work. We have a behavioural economics focus, looking at how customers interact with products, services and firms.

Assessing multiple firms in this way allows peer comparison and a more nuanced, specialist analysis of the drivers of risks. We 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 are transparent about the areas we are interested in and why, and engage with the industry at an early 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 address our response to all firms in the relevant market, not just those that have been involved in the assessment work. Our responses may include guidance to the industry, policy changes, targeted firm communications, or consumer communications. We generally publish the results of our larger 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.

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 do so, in an orderly manner.

Where we are the sole prudential supervisor for a firm, we ensure that minimum prudential requirements are met and monitor your compliance with applicable rules and requirements. We carry out detailed analysis and set financial resource requirements for the most prudentially significant firms, and engage with you proactively at signs of strain or crisis. This can include forming a crisis-management group representing relevant areas of expertise, to explore suitable courses of action.

We may also challenge you to consider and develop your wind-down plans, including recovery options, and whether you would need to hold additional capital to enable an orderly resolution.

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 in which it operates
- 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. The vast majority of 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

For P1 and P2 firms, we carry out comprehensive capital and liquidity analysis and assess their risk-management capability.

Prudential risk analysis and monitoring, including assessment and setting of financial resource requirements, is part of the end-to-end supervisory framework and is an important early warning system. We also monitor your prudential returns to identify early warning signs, as well as checking for errors or inconsistencies.

This helps us target supervisory work where risks have been identified that could lead to consumer detriment, or where a firm is failing and we need to consider the issues raised by its wind-down. We also consider the potential for one legal entity to contaminate other members of a group, or the rest of the sector.

Financial resources requirements (FRR)

The FCA Handbook specifies minimum FRR for all firms. You must maintain sufficient resources to meet your financial obligations at all times, and must be able to show how you have determined what is sufficient. This is the starting point for any prudential supervisory review.

The specific scope and nature of FRR varies by firm type and permissions:

- **P1 firms have a capital and (if applicable) liquidity assessment every two years.**

- **P2 firms have a capital and (if applicable) liquidity assessment every three to four years.**

These involve examining your own assessment of your position and requirements, along with data and documents we have requested and any other information our supervisors have. We then provide firm-specific guidance for maintaining capital and liquidity levels until the next assessment period.

We also expect you to have suitable wind-down plans in place, so that if you were to fail you would be able to do so in an orderly way without adversely affecting the market or your consumers.

When we do see the signs of financial distress in any P1 or P2 firms, we 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 these firms calculate and meet their financial resources requirements. This applies unless the firm is captured by the Capital Requirements Directive (CRD IV), in which case it is treated in a manner similar to P2 firms. 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 whether firms in a peer group are meeting their financial resources requirements

Interaction with the Prudential Regulation Authority (PRA)

All firms prudentially regulated by the PRA – deposit-takers, insurers and designated investment firms – are regulated for conduct purposes by the FCA. The two regulators will interact for these dual-regulated firms.

If you are a group that includes entities that are prudentially regulated by the PRA, the PRA will typically be the lead consolidating supervisor and will conduct a group-level assessment of capital and liquidity requirements, sharing its results with us. We are responsible for any entities in the group for which we are the sole regulator. You must assure us that capital and liquidity requirements for these entities are adequate, independently of the group consideration. In these cases, although we may rely on data we receive via the PRA, we may need further, more detailed information and make specific data and information requests to be able to discharge our duties.

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