

June 2014

**Financial Conduct Authority**



## **Tackling serious failings in firms**

**A response to the Special Measures proposal of the  
Parliamentary Commission on Banking Standards**

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## A. Introduction

In *Changing Banking for Good*, the Parliamentary Commission on Banking Standards (the Commission) recommended that regulators be given additional powers to address the 'failure of standards at the most senior levels of a bank'. In response, the Financial Conduct Authority (FCA), HM Treasury (the Treasury) and the Prudential Regulation Authority (PRA) concluded that regulators were able to address these failings by applying existing powers appropriately.

The FCA has wide-ranging powers to tackle failings of standards within banks. We can impose formal requirements on firms to undertake specific actions, or cease a particular action, in order to meet our operational objectives. The Financial Services Authority (FSA) had many of the same powers, yet was unable to address the underlying issues of poor standards, governance and culture in banks. This statement of policy sets out how the FCA uses its powers, as part of our supervisory approach, to address failings in standards, governance and culture. This paper:

- Sets out how we can meet the Commission's recommendations within the FCA supervisory model.
- Describes how we address standards, governance and culture as part of regular supervision.
- Describes our new approach, 'Enhanced Supervision', when fundamental failings of standards, governance and culture are identified.
- Explains how the FCA and PRA work together to ensure that systemic weaknesses within firms are identified and addressed effectively and efficiently.

The approach outlined below sets out our supervisory model, which we apply to all regulated firms. This includes the supervisory model in place since April 2013 and the new Enhanced Supervision approach we have developed to meet the Commission's recommendations. For banks, building societies and credit unions, our ability to address failures in standards will be further enhanced by the new Senior Managers and Certified Persons regimes. We will consult on these regimes in summer 2014.

## B. Meeting the Commission's Recommendations

In *Changing Banking for Good*, the Commission noted that many failings in the banking sector had common roots in underlying issues of banking standards and governance. To address such underlying issues, and to reduce the risk of failings 'falling between the gaps' of the new regulators, the PCBS recommended the introduction of a 'Special Measures' tool.<sup>1</sup>

During the House of Commons debate of 11 December 2013, the Chairman of the Commission described the Special Measures tool as constituting a step between "enforcement at one end of the spectrum and day-to-day supervision at the other".<sup>2</sup> The tool would enable the regulators to address concerns in the bank at a supervisory level, but with a greater degree of formality and regulatory scrutiny than would normally apply. In practice, the proposed tool would take the form of a formal commitment by the firm to address the identified serious failings in its banking standards and corporate governance.<sup>3</sup>

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<sup>1</sup> *Changing Banking for Good*, para. 1063.

<sup>2</sup> Andrew Tyrie, House of Commons Hansard Debates on 11 Dec 2013, Column 262f.

<sup>3</sup> *Changing Banking for Good*, para. 971.

The Commission drew a comparison with the approach of the Office of the Comptroller of the Currency (OCC) to identifying serious failings within its firms. Prior to entering into formal enforcement action, the OCC has a series of increasingly strong actions available to compel a firm into action. These include a commitment letter by which a firm commits to rectifying a problem and a Safety and Soundness Compliance Plan, which describes the steps a firm will take to remedy deficiencies.

We agree with the Commission that underlying issues of standards, corporate governance and culture within firms have a significant impact on the integrity of the UK market and on consumer outcomes, and that regulators should in appropriate cases deploy tools that constitute a step between day-to-day supervision and enforcement action. We can achieve the measures recommended by the Commission using existing powers and our new Enhanced Supervision model.

	<b>Changing Banking for Good Recommendation<sup>4</sup></b>	<b>FCA supervisory model</b>
Independent reports	Ahead of placing a bank in Special Measures, the regulators would commission an independent report to understand whether their regulatory concerns were an indicator of wider conduct or standard failings. <sup>5</sup>	We are able to commission independent reports using powers under s166 of FSMA.  In April 2013, FSMA as amended by the 2012 Act, gave us the power to contract directly with Skilled Person Firms. This gives us more control over the appointment of an appropriate Skilled Person and process.  Since the FCA was established in April 2013, we have commissioned Skilled Person reports in connection with culture and governance at 22 firms (including six banks). Four of these were commissioned directly.
Notification of the bank	The regulators would be required to notify the bank of their concerns and give it an opportunity to either demonstrate that their concerns were being addressed or that they were unfounded. <sup>6</sup>	Supervisors are in regular dialogue with larger firms. As part of regular supervision, we discuss concerns with firms, allow them to demonstrate that concerns are being addressed and inform them of any actions that we believe are necessary to address issues.

<sup>4</sup> *Changing Banking for Good*, para. 971

<sup>5</sup> Ibid.

<sup>6</sup> Ibid, para. 973.

	<b>Changing Banking for Good Recommendation<sup>7</sup></b>	<b>FCA supervisory model</b>
Formal commitments	Where it is found that there were problems that required rectification, the bank would be required to enter into a formal commitment with the regulators to address these and monitor progress in addressing concerns.	<p>We will require formal commitments from firms when particular issues are identified. We use judgement to determine which form of commitment we require, which range in significance as follows:</p> <ol style="list-style-type: none"> <li>1) As part of regular supervision, we set out one, two or three-year work programmes for major firms and monitor progress against these work programmes on an ongoing basis.</li> <li>2) Where there are more serious issues, such as fundamental failings of governance, we can require boards of firms to make a formal commitment to address those issues within an agreed timeframe.</li> </ol> <p>For still more serious issues, or where other approaches have not been effective, we will consider the use of our formal powers to impose requirements under s55L of FSMA (OIREQ). These powers enable us to impose a requirement on a firm to undertake or cease a particular action. In practice, we often ask firms to agree to make a formal commitment on a voluntary basis in the first instance.</p>
Formal, heightened, regulatory scrutiny	This formal, heightened, regulatory scrutiny would elevate issues above day-to-day supervision without necessarily resulting in an enforcement referral. There would be intensive and frequent monitoring by regulators.	<p>When we see evidence of serious failings in governance, the firm will be formally subject to Enhanced Supervision. This triggers a formal review of what supervisory tools and powers should be used to mitigate the issues and risk.</p> <p>Firms will be notified that they are subject to Enhanced Supervision, and these issues will be reported to our Executive Committee on a monthly basis and to the FCA Board.</p>

<sup>7</sup> *Changing Banking for Good*, para. 971

	<b>Changing Banking for Good Recommendation<sup>7</sup></b>	<b>FCA supervisory model</b>
Individual accountability	The responsibility for the implementation of the remedial measures would be passed on to an individual within the bank.	<p>We use 'attestations' to obtain formal confirmations from responsible senior individuals at firms that remedial measures have been implemented.</p> <p>This typically takes the form of a CEO, Chairman or other relevant senior person formally attesting to the fact that they will take all reasonable steps to tackle a specific issue and accept accountability for doing so.</p> <p>Individual accountability will be further reinforced under the new Senior Managers and Certified Persons regimes.</p>
External oversight	The regulators might also require oversight by an independent person of the process. <sup>8</sup>	We are able to require independent oversight using powers under s166 of FSMA.

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<sup>8</sup> Ibid, para. 972.

## C. FCA supervision of standards, governance and culture

The FCA approach to supervision is judgement-based, pre-emptive and focused on the biggest issues that drive consumer outcomes and market integrity. This approach enables us to assess standards in firms and intervene using formal powers and other regulatory tools when standards are not met. We examine how firms mitigate risks by looking at (i) frontline business processes and (ii) systems and controls. However, the FCA approach places increased emphasis on how firms are really run, on (iii) culture, (iv) governance and (v) business model analysis.

This section sets out how we set expectations, assess standards and evaluate firms as part of regular supervision.

### Setting expectations

We set clear expectations that firms are required to not only to comply with the letter of our rules but run their businesses in a manner consistent with our operational objectives.

We expect firms to have a **culture** that places customers and market integrity at the heart of their business. Culture is evidenced through the way firms conduct their business, what firms expect of staff, and their attitude towards customers. It is for firms to determine what culture is appropriate for them and to demonstrate that culture from the top down.

We want firms to be commercially successful. But **business models and strategies** should not aim to maximise profit at the expense of customers, who should get products and services that meet their needs. It is for firms to decide what business model and strategy is appropriate for them. We expect firms to demonstrate how they identify, assess and mitigate strategic risks.

The **governance** of firms, through senior management and boards, plays a key role in determining business models, strategies and business practices, and ensuring appropriate systems and controls are in place. We expect boards to clearly explain to us the conduct risks within their strategies, and we pay close attention to the way they implement consumer and market-focused values.

### Assessing standards, governance and culture

The FCA assesses business models, governance and culture as part of regular supervisory activities. We operate a three-pillar model:

- Pillar I            proactive firm supervision (the Firm Systematic Framework)
- Pillar II            event-driven, reactive supervision
- Pillar III            issues and products supervision

Specific events or issues identified under Pillars II and III are an important part of our approach and contribute to our overall view of specific firms. But under the FCA's Firm Systematic Framework, we are formally required to make judgements about firms as a whole rather than focusing on individual issues or processes. Activities within this framework include:

- **Business Model and Strategy Analysis** – We pay particular attention where we see common indicators of heightened risk. Examples of indicators include: fast growth; aggressive growth targets; high levels of profitability; strategies that depend on cross-selling; or products with unclear features or pricing.
- **Deep dive assessments** – We conduct in-depth assessments to examine particular risks. Deep dives focus on one of four risk groups – culture and governance; product design; sales and transaction processes; and post-sales

and transaction handling. They enable us to identify the root causes of risks and to test how firms manage and mitigate risks at every level of the business.

- **Proactive engagement** – We have frequent engagement with key individuals within the largest firms, both senior managers and people involved in day-to-day operations at different levels within a firm. This helps us to understand how strategies, culture and governance translate into real working practices.

#### Supervision in action – Deep dive assessment

One firm had highly aggressive growth plans in a number of divisions covering various sectors. During meetings, senior management could not clearly articulate how these plans would be executed safely. This raised questions around the adequacy of the governance of the group's strategy implementation and business planning, and the potential for creating poor consumer outcomes.

To test the firm's governance arrangements, we did a deep dive assessment to explore how it set strategy, business plans and targets.

We also examined the strategy and business plans for one product in one division of the firm. This way we could understand how the plans were being developed and see the conduct risk governance arrangements working in practice. This part of the deep dive not only included a review of the senior management level but also a number of levels below, including operations, frontline sales staff and records of customer interactions.

At the end of the deep dive, we had a good understanding of the firm's culture and the effectiveness of conduct risk governance. We could then make judgements and conclusions which the group accepted. As a result, the group lowered its business targets and strengthened its governance.

#### Firm evaluation

The firm evaluation is a summary of our view of a firm or group, where we examine all the information we have about it, including business model analysis and deep dives from the Firm Systematic Framework, thematic issues and products work, events-based reactive work, sector analysis and any specific risks relating to financial crime or client money and assets. We also assess whether firms are meeting the threshold conditions set by the FCA. Taking this into account, we can judge and explain our view of:

- The risks the firm poses, and our view of their root causes.
- Our strategy and work programme for the next supervision cycle, to address and mitigate these risks.

For the most significant firms, these assessments are made on an annual or bi-annual basis. We provide this formal assessment in a letter to the Board of Directors and will usually attend a Board meeting to present our evaluation and understand the firm's view. We carry out an interim review of the firm evaluation every six months. For other firms, we examine peer groups of firms with similar business models or risks at least once a year.



### Supervision in action – Firm evaluation

Our overall evaluation of a firm showed it did not focus enough on customer outcomes in its mortgage business. Our most recent deep dive had raised issues about how customers were considered when new products were designed and we had evidence that senior management discussions were focused on revenue concerns to the exclusion of customer outcomes. The firm was also involved in a large remediation exercise following a sales review of its interest-only mortgages.

We raised these concerns with the firm, and then met the CEO and Chairman to discuss them.

As a result, the firm accelerated planned changes to ensure customer outcomes were considered in the decision-making process at every level of the business. The firm began recruitment to reduce the operational responsibilities on its Customer Director, who could then focus on the end-to-end customer experience.

We will review these responses through a future deep dive assessment.

## D. Enhanced Supervision

Where we believe a firm presents serious risks to our objectives, due to a serious failure of culture, governance or standards and we do not think that our usual supervisory approach will be sufficient to tackle those issues in a timely way, the firm will be made formally subject to Enhanced Supervision.

Indicators of the kinds of failings that would lead to Enhanced Supervision (or other regulatory action) may include:

- the observation of numerous or especially significant conduct failings or repeated failings that when examined individually might not be considered serious
- occurrence of failings in several business areas, as this is an indicator of wider cultural issues within the firm
- a poorly functioning Board, for example failing to challenge executives or take a lead in considering conduct
- evidence of control areas such as Risk, Compliance and Internal Audit being poorly managed, under-resourced, or unable to make their voices heard at Board level
- evidence of weak risk management (we may consider the PRA's findings in relation to prudential risk management), or
- evidence of other weaknesses in the way in which the Board and senior management influence key cultural factors, for example 'tone from the top', pay and incentives, and their adherence to the organisation's values.

Once a firm is put in Enhanced Supervision, the supervisors will review their supervisory strategy and ensure there is a plan in place to return the firm to normal supervision by a specified date. This will include consideration of which of our tools and powers described in Annex 1 are most suitable to address the failings. Progress against this plan will be monitored at regular intervals and corrective action taken if it is not on course to deliver a successful outcome.

We use judgement rather than a formal process for determining whether firms should be placed under Enhanced Supervision, and what action should be taken under Enhanced Supervision. However, our approach might typically follow the path set out below:

- We will normally require the firm's Board to formally commit to remediation measures (similar to the approach adopted by the OCC). Where we think that oversight by an independent person would be valuable, we will ask the firm's Board to engage a suitable person in this role, using powers under s166 of FSMA.
- We would review the effectiveness of remediation measures and determine whether the firm could revert to regular supervisory processes.
- If we believed that the outcome obtained from the Board commitment was not effective in addressing our concerns, we would consider the use of other tools and powers. This may include use of the OIREQ power to place requirements on the firm to take certain actions. In certain cases, we may believe it necessary to use such powers from the outset.

Enhanced Supervision helps the FCA to address weaknesses in standards, governance and culture in firms. In some cases, Enhanced Supervision will be followed by an enforcement

investigation. However, it is important that regulators use judgement, rather than a set of consequential processes, to determine what regulatory tools and powers are appropriate. Enforcement investigations may therefore begin without a firm having been placed in Enhanced Supervision.

Our enhanced approach is designed to tackle the most serious failings in standards, governance or culture within a firm. However, as the Commission noted, "Improving standards and culture of major institutions, and sustaining the improvements, is a task for the long term". Through the use of the above approach, we seek to tackle the underlying failings at a senior level in firms. Cultural change in the wider institution is likely to take much longer to happen.

## **E. Working with the PRA**

The FCA has a duty to co-ordinate with the PRA in the exercise of its public functions, including supervision. A Memorandum of Understanding (MoU) between the regulators describes how we co-ordinate in a way that supports each regulator's ability to advance its own objectives. Co-ordination is also assisted by the membership of the CEOs on each other's board and on the Financial Policy Committee.

The FCA and PRA will share their respective views on key conduct and prudential issues facing a firm. The FCA's Watchlist monitors those firms that pose the greatest risk to our statutory objectives and, for dual-regulated firms, this information is shared with the PRA. Supervisors of dual-regulated firms co-operate routinely and meet at least once a year (twice a year for the most significant firms) at domestic colleges to discuss issues of common interest or ad hoc on specific issues. We would expect a discussion to take place at an appropriate level between the two regulators. For the most significant firms, these discussions will be at a senior level.

Where we identify concerns with a specific firm, we will discuss these with the PRA and, wherever possible, come to a common view on the underlying issues and the course of action that we will take. We will inform the PRA when we place a firm under Enhanced Supervision although for such significant issues as would lead us to place a firm under enhanced supervision, we would expect to have already been discussing these issues with the PRA. If the use of formal powers is required to address failings in standards, governance or culture, we will seek to take joint action if appropriate. The Financial Services Act and the MoU require the regulators to consult before imposing requirements on firms and ahead of a firm voluntarily varying its permission.

However, we may also choose to take action when the PRA does not wish to do so, for example because the firm's failings are specifically failings of conduct. We will also take unilateral action for firms not regulated by the PRA

## **Annex 1 – FCA powers**

As set out in section B, we have a series of supervisory tools and powers available to pre-emptively tackle concerns before they result in poor consumer outcomes or compromise market integrity. While we look to firms to co-operate with us in resolving supervisory issues, we will not hesitate to use formal powers where we consider them appropriate. We formally review whether these powers are appropriate when a firm is placed in Enhanced Supervision.

### Skilled Person reviews

The FCA has the power to commission Skilled Persons reviews under Section 166 of FSMA and we do so where we believe that this would add substantially to our understanding of the issues. The ability for the FCA to contract directly with the Skilled Person (as opposed to requiring a firm to do so) was granted under the Financial Services Act 2012. This gives the FCA more control over the appointment of an appropriate Skilled Person and process and addresses the Commission's concern with regard to the Skilled Person lacking independence. It is particularly relevant in this context that, when contracting directly, the FCA initially pays the costs of the Skilled Person firm, giving us further assurance of the Skilled Person firm's impartiality. These costs are later charged back to the firm.

Since the FCA was established in April 2013, we have commissioned Skilled Person reports in connection with culture and governance at 22 firms (including six banks). Four of these were commissioned directly.

### Requirement powers

Under Section 55L of FSMA, the FCA has a power to impose a requirement on a firm to undertake or cease a particular action where it is desirable to take this action to meet the FCA's operational objectives (Own Initiative Requirement or OIREQ). Imposing the requirement may not be necessary if the firm agrees to undertake the action and gives a formal undertaking to this effect. If the FCA feels the imposition of a formal requirement is still appropriate, and the firm agrees to the requirement being imposed on the firm, we then speak of a voluntary application for the imposition of a requirement as opposed to a requirement imposed by the FCA on the firm against its wishes.

The requirement power is therefore an important tool, which enables the FCA to take early intervention action, to address ongoing conduct issues that pose a risk to consumers or market integrity.

### Variation of permission powers

Another supervisory tool that we have at our disposal to deal with fundamental failings in standards and culture is to remove a firm's permissions through an Own Initiative Variation of Permission (OIVOP) under section 55J FSMA.

### Asset requirement powers

We can also prohibit a firm from dealing with its assets or any consumer assets held by the firm through an asset requirement under section 55P FSMA.

### Use of early intervention powers

The FCA has taken early intervention action based on its OIREQ, OIVOP or asset requirement powers in a number of cases since its creation, including:

- obtaining an own initiative requirement to secure customers' money held by a firm under Section 55P of FSMA
- a voluntary application by a firm for the imposition of a requirement to return client money to investors and limiting its ability to hold client money other than for other FCA-regulated firms
- a voluntary application for the imposition of a requirement by a firm to write to customers to warn them that their insurance cover might not exist
- a voluntary undertaking from an authorised firm to cease taking on new high risk clients until its anti-money laundering systems and controls were adequate, and
- a voluntary agreement by a firm to halt sales of a specific product and to provide redress to affected customers

In addition to the many instances in which FCA Supervision secures the cooperation of firms to take steps to reduce risks to consumers and market integrity, in the financial year 2013/2014, FCA Supervision and Enforcement staff worked together on 21 separate occasions to take early intervention action of this type.