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FCA'S APPROACH TO SUPERVISION

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The Financial Conduct Authority (FCA) has a very broad range of regulatory responsibilities. It regulates around 58,000 firms ranging from small high street insurance brokers to the largest banks and insurers, as well as having broader responsibility to supervise markets and exchanges.

Therefore the FCA has to adopt a risk-based and disciplined approach to supervision as it cannot cover all areas equally for which it is responsible. The FCA has made it clear that it cannot operate a "zero failure" regime In fact the Prudential Regulation Authority (PRA) regulates the financial soundness of banks and insurers, not the FCA.

Why does the FCA supervise?

The FCA supervises authorised firms and individuals to:

- improve the way in which the UK financial system works;
- improve how firms conduct their business; and
- reduce harm, actual and potential, to consumers and markets.

What are the FCA's objectives?

The FCA's overarching strategic objective is to ensure the relevant markets function well. To support this, it has three operational objectives:

- to secure an appropriate degree of protection for consumers;
- to protect and enhance the integrity of the UK financial system; and
- to promote effective competition in the interests of consumers.

Supervisory principles

The FCA has historically been criticised for being reactive, lacking a sense of urgency and generally being ineffective when it comes to supervising firms.

The FCA is now guided by a number of supervisory principles including:

- **Forward-looking**: the FCA aims to pre-empt or address poor conduct, so the risk and any associated harm, does not materialise, or if it is likely to do so, it does not cause significant harm to consumers or markets.
- **Focus on strategy and business models**: the FCA aims to identify emerging risk of harm and mitigate the risk presented by firms' strategies and business models.
- **Focus on culture and governance**: the FCA looks at what drives behaviour within a firm and behaviours that are likely to cause harm. This includes the firm's approach to managing and rewarding people and the effectiveness of its governance arrangements in identifying, managing and mitigating the risk of harm to consumers and markets.
- **Focus on individual and firm accountability**: the FCA approves, and holds accountable, senior individuals whose decisions and personal conduct have a significant effect on the conduct of their firm. The FCA has been criticised in the past for not bringing enough cases against directors and senior managers (particularly against the senior management of banks following the financial crisis), and in 2016 the FCA responded by introducing a new Senior Managers and Certification regime (SMCR), which applies to banks, insurers and some other large firms. The FCA is extending the SMCR to all regulated firms with effect from 9 December 2019.
- **Proportionate and risk-based**: the FCA focuses on those firms whose misconduct would cause the most harm.

FCA priorities for retail markets

The FCA's priority is to protect consumers from being sold products that are unsuitable for their needs; not receiving appropriate support when they are vulnerable or in financial difficulty; not receiving adequate help where things go wrong; and being misled by firms or not being given enough information to fully understand a product's total cost or the risks and obligations they may be taking on. The FCA's response to the mis-selling of Payment Protection Insurance (PPI) is an example of their action in this area.

FCA priorities for wholesale markets

The FCA's priority is to focus on managing conflicts of interest and ensuring participants are clear about the obligations they owe; and preventing misconduct and maintaining the stability of the financial markets. Tackling market abuse has been a strong priority for the FCA in this area, with a number of cases brought against individuals with City backgrounds, including convictions for insider dealing.

Supervisory approach

The focus of the FCA's supervisory approach is on:

- **Business models**: to understand firm's strategies, allowing the FCA to anticipate potential problems in firms and markets and identify whether there is poor alignment between firms' profit incentives and the interests of consumers and markets functioning well.

Typical indicators of high risk business models include aggressive pro-active selling or cross-selling; products with unclear or complex features and pricing; and conflicts of interest.

- **Culture**: to provide feedback on, and to challenge, the drivers of behaviour that it observes and the role individuals play within firms. The "tone at the top" set by senior management is an important cultural indicator for the FCA.
- **Prudential soundness**: by setting minimum capital and/or liquidity and adequate resources requirements on firms, the FCA (and the PRA for banks and insurers) aims to avoid disorderly failure and minimise the harm to consumers or the integrity of the UK financial system.

How the FCA supervises

The FCA takes a pro-active, intelligence driven, and data led approach. It uses data from complaints, whistleblowers, its firm and consumer contact centre, regulatory filings, other regulators and competitors.

The FCA is trying to be more on the front foot, rather than reactive, For example in the past it has tackled misconduct at the enforcement stage, after things have gone wrong, rather than earlier in the process using its supervisory powers: the mass mis-selling of payment protection insurance (PPI) is a good example of this. However now the FCA is looking to firms to take responsibility at an earlier stage in the design process, for example by using its product powers, which have been enhanced as a result of MIFID II. Firms selling products to retail customers must think carefully about their target market and the suitability of the product for that market. They must document the design and marketing process, and consider appropriate distribution channels. The FCA can intervene even before products are taken to market, if it considers they are too high risk for retail consumers.

There have been other instances where the FCA appears to have been slow to act. More recently, the FCA shut down Beaufort Securities in a joint operation with the FBI, but this happened only after investors complained about lost money, and the US authorities appeared to be in the lead.

The FCA is also taking a more robust approach to its supervision of financial markets and exchanges. As a result of the increased report of transactions introduced by MIFID II from 3 January 2018, the FCA has a much bigger "fishing net", and now processes 30 million transaction reports per day. Furthermore, these reports provide much better intelligence on who is the decision maker behind the transactions. The improved intelligence and detection systems make it easier for the FCA to bring enforcement cases for insider dealing and other types of market abuse like market manipulation.

Keeping the financial markets clean also includes tackling money laundering. The FCA Director of Enforcement, Mark Steward, recently stated that the FCA may use its criminal powers more often to combat money laundering in the capital markets. Previously, the FCA tended to rely on its regulatory powers to fine firms for systems and control failures under the FCA rules, but the use of criminal powers should have a greater deterrent effect, although in practice this will be reserved for the more serious cases.

The FCA is taking action to address its perceived shortcomings. Its key focus now is tackling the root causes of problems, and culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred and caused harm to both consumers and markets.

The FCA's focus on culture and governance, as well as individual and personal accountability under the SMCR, represents a significant milestone. The SMCR provides for a statement of responsibilities and a responsibilities map, which makes it clear who is responsible for what and means in theory that the FCA will be able to hold senior managers to account more easily for misconduct.

This matters because every day the UK population relies on financial services - from basic bank accounts to car loans, mortgages, pensions and investment products. Consumers should have confidence in these services and high expectations of the firms that provide them.

Overall, FCA regulated firms can expect more intrusive regulation, with the FCA reviewing business models and "kicking the tyres" more often. However, the FCA's biggest project (and highest priority) for this year is planning and implementing Brexit, which will involve significant review and re-writing of the FCA rulebook. So FCA's ability to be an effective regulator will depend on the resources available and will be depend (like so many other areas) on how Brexit develops.

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