

Supervision under the Twin Peaks regime

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Introduction

It is now over a year since the Financial Services Authority was abolished and its responsibilities split between two new UK regulators – the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”). The new twin peaks system, under which banks and insurers are subject to supervision by the PRA for prudential issues and the FCA for conduct issues, is still in the process of bedding in, with both regulators still developing their individual regulatory styles and approaches.

In this article we focus upon two key developments in the PRA’s and the FCA’s supervision of firms in 2014: the PRA’s proposed new Fundamental Rules for firms; and the FCA’s new Supervisory Framework documents. We conclude with some observations on how the dual supervisory regime is working in practice.

Key developments in PRA regulation – proposed new Fundamental Rules

At the beginning of this year, the PRA issued a Consultation Paper (CP2/14) seeking input on (among other things) a new set of high level duties, which are to be known as the Fundamental Rules. The Fundamental Rules are intended to replace the Principles for Businesses that the PRA inherited from the FSA. Like the Principles for Businesses, they are framed at a very high level of generality; however, they differ significantly from the Principles for Businesses in some key respects.

The PRA has always said that, over time, its rulebook would diverge from the FCA Handbook and become a discrete PRA set of rules. The proposed new Fundamental Rules are the first really significant step in that direction.

The text of the proposed new Fundamental Rules is set out below:

1: A firm must act with integrity.

2: A firm must act with due skill, care and diligence.

3: A firm must act in a prudent manner.

4: A firm must at all times maintain adequate financial resources.

5: A firm must have in place sound and effective risk strategies and risk management systems.

6: A firm must organise and control its affairs responsibly and effectively.

7: A firm must deal with its regulators in an open, cooperative and timely way and must appropriately disclose to the PRA anything relating to the firm of which the PRA would reasonably expect notice.

8: A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.

9: A firm must not knowingly or recklessly give the PRA information that is false or misleading in a material particular.

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Although some of the wording of these new duties quite clearly tracks back to aspects of the Principles for Businesses, we see the most significant new elements to be as follows:

- It is proposed that there should be a brand new over-arching requirement for a firm to “act in a prudent manner” in everything that the firm does (Fundamental Rule 3). There was nothing similar under the FSA’s Principles for Businesses; this new rule gives the PRA a remarkably broad remit for questioning a firm’s approach to managing its business, particularly on strategic issues, and may well be interpreted as materially restricting a firm’s ability to accept risks that it has fully assessed and understood. Particularly for firms that are small in size, with no systemic impact, it is in our view highly questionable whether this duty is necessary or appropriate.
- Principle 3 of the Principles for Businesses currently requires a firm “to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems”. This duty is proposed to be replaced by two new PRA rules (Fundamental Rules 5 and 6) that will impose strict liability on firms where problems occur. Each PRA firm will be required to “have in place sound and effective risk strategies and risk management systems”, and “to organise and control its affairs responsibly and effectively”. As a consequence, firms will be liable to significant fines by the PRA whenever a problem has occurred, even where all reasonable steps had been taken to manage the relevant risks and control the business.
- The proposed new Fundamental Rule 8, requiring firms to prepare for resolution, would for the first time require insurers to prepare and have in place resolution plans. Complying with this requirement, if indeed it is introduced following the consultation, will be a significant undertaking for insurers.

As a more general matter, dual-regulated firms will have two sets of high level principles to comply with. It is important to bear in mind that the Significant Influence Function holders within dual-regulated firms will be personally responsible for ensuring that the area of the firm’s business for which they are responsible complies with these parallel sets of high level rules. Given the proposed move to an absolute, strict liability, approach to risk management and systems and controls, senior management of banks and insurers are likely to be undertaking large scale reviews of their firm’s existing compliance and risk management frameworks to ensure that they are sufficiently robust and fit for purpose.

Key developments in FCA regulation – new “FCA’s Approach to Supervision” documents

In March this year, the FCA published a series of documents (one for each of its four risk categories of firm) outlining its new supervisory framework. In those documents, the FCA offered its clearest summary yet of the scale and type of supervisory interaction firms in each category should expect; and it also gave an important insight into the standards that the FCA is now expecting of itself.

In relation to the FCA’s supervisory framework, the FCA assigns each authorised firm to one of 4 categories for each of conduct and prudential risk, where category 1 poses the highest risk to the FCA’s statutory objectives and category 4 the lowest risk. The FCA sets out in detail what supervisory attention will be given to each category of firm.

For firms in categories 1 and 2 (which contain the 130 most significant groups), there will be a high level of scrutiny from their dedicated FCA supervision teams. For category 1 (C1) firms, the FCA will undertake a full scale Business Model and Strategy Analysis (BMSA) every two years, with a review after one year. This will include analysis of group and business line financials; product strategies and profitability; interdependencies with prudential issues; and data about customers such as complaints and persistency of breaches. In addition, C1 firms are told to expect two deep dive assessments on aspects of their business during each

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annual assessment cycle (with each deep dive focusing on one of four risk groups – culture and governance; product design; sales and transaction processes; and post-sales / services and transaction handling).

The BMSA and deep dives, as well as other regulatory interaction, will feed in to an annual risk evaluation on the group – in which the FCA will identify the risks the group poses (and their root causes); and the FCA's strategy and work programme for the next supervision cycle, to address and mitigate those risks.

C2 firms should expect to receive a similar approach to C1 firms, but on a less frequent cycle. The Business Model and Strategy Analysis is undertaken annually but as part of a peer analysis of firms sharing similar business models or activity rather than individually. Risk evaluations will ordinarily be undertaken every other year, with one or two deep dive assessments expected during every two-year cycle.

Firms in categories 3 and 4 will not have a dedicated FCA supervisor, and so will ordinarily interact with the FCA only via its Contact Centre or as part of thematic reviews. These firms will therefore experience very little supervisory contact and should expect a firm-specific supervision visit from the FCA approximately once every 4 years. Where C3 and C4 firms are involved in thematic reviews, there is a risk that the issues under review give the FCA an incomplete or unrepresentative view of the firm's systems and controls, and so can sometimes unfairly lead to a sharp increase in regulatory attention to the firm. As a result, C3 and C4 firms in particular should attach a great deal of significance to their involvement in thematic review exercises and should deal with FCA thematic reviews with the utmost care and caution.

The new *FCA's Approach to Supervision* publications also set out a list of 10 "Supervision Principles" that the FCA states it will adhere to, as follows:

Ensuring fair outcomes for consumers and markets.

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.

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.

An emphasis on individual accountability, ensuring senior management understand that they are personally responsible for their actions – and that we will 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 will 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 Financial Ombudsman Service, Financial Services Compensation Scheme, Money Advice Service and international regulators.

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Whilst some of these Supervision Principles merely repeat what the FCA has already said elsewhere, it is a positive development for firms that the FCA has pledged in such a formal way to:

- communicate openly with firms
- deliver a joined up approach, and engage effectively with the PRA, and
- focus on the most significant issues.

Firms should bear in mind these promises when they are experiencing difficult interactions with the FCA. The FCA's powers are wider and less fettered than ever before; these statements made by the FCA as to the standards it will apply to itself are as close to a check and balance on the FCA's powers as firms will find within the new regime.

Concluding observations

One surprising feature of the new dual regulatory system is the extent to which each of the PRA and FCA seems happy to take responsibility for questioning a firm's conduct in an area that seems clearly to be the core responsibility of the other regulator.

Our experience over the last year has been that, with the exception of capital resources, the FCA as "conduct regulator" appears to view all aspects of a firm's activities to be properly within its regulatory remit. Issues such as general Board effectiveness, succession planning and selection of individuals for Board-level positions – which for a bank or insurer would appear to be the central responsibility of the PRA – are matters that the FCA has taken responsibility for pursuing.

Equally the PRA is also taking a wide view of its statutory duties, particularly in the insurance sector as a result of its "insurance objective" at Section 2C of FSMA. The PRA's insurance objective is "*contributing to the securing of an appropriate degree of protection for those who are or may become policyholders*" and this is being regularly cited by the PRA as a rationale for supervising how insurers are managing their conduct risks.

While we all expected that there would be some overlap of the areas of responsibility of the PRA and FCA, the extent to which each regulator seems keen to supervise (and criticise) firms in areas that are clearly more properly the domain of the other regulator, is both surprising and problematic. This duplication is very significantly adding to the regulatory burden of firms, a situation exacerbated by the lack of effective communication on an individual firm level between the PRA and the FCA.

The danger for the UK financial system is that the purposefully hostile, overbearing and unnecessarily duplicative nature of the current regulatory regime will lead to firms finding other jurisdictions in which to base their operations. We are already observing an increasing number of firms seeing this as a realistic step that they may wish to take.