

## Making Sense of Conduct Risk



Will German  
Associate Partner  
Avantage Reply

### Observations on the FCA's approach and firms' response

On 1st April 2013 responsibility for "conduct" regulation<sup>1</sup> of the UK financial services industry formally transferred from the Financial Services Authority (FSA) to the Financial Conduct Authority (FCA).

During the 18 months of "twin peaks" regulation in the run up to the dissolution of the FSA and since the FCA formally assumed its role there have been significant changes to the way in which firms are regulated. As well as the statutory changes to its remit and objectives, the FCA has a number of new powers and has adopted a new supervisory approach better suited to delivering its new role. Looking back on the FCA's supervisory activity since its inception reveals an aggressive new regulator with an approach that favours enforcement of existing requirements over making new policy.

As a direct result of this new approach, firms have been forced to make substantial changes as they seek to adapt to the new regulatory challenges. Firms have sought to enhance their management of conduct risk by strengthening their risk governance and control function operating models. They have formalised and consolidated their management of Conduct Risk and sought to break down silos in risk measurement and mitigation. At the same time, they have strengthened their Conduct Risk functions with senior appointments and are investing in enhanced data analytics capabilities to allow proactive early identification of emerging issues. Finally, they are seeking to change their culture from board level down so that appropriate

<sup>1</sup> The FCA is also responsible for "Prudential" regulation for financial services firms whose failure would be less likely to result in a systemic impact.

conduct towards customers, employees, markets and regulators becomes the central consideration in the ways in which they do business.

As the FCA approaches its first birthday, this paper sets out Avantage Reply's observations on its approach to date, how firms have responded to the challenge and what can now be considered best practice. In addition it sets out some questions that firms should be asking themselves to ensure that their approach towards Conduct Risk is fit for purpose.

### Part 1: The FCA's approach towards regulating conduct risk

Since it was first mooted as the Consumer Protection & Markets Authority<sup>2</sup>, the FCA's inception and creation has been an intensely political initiative with all parties seeking to make political capital out market and supervisory failures in the run up to the financial crisis and subsequently. As a result, the FCA's remit and approach is, at least in part, a reaction to the perceived and real failures of the FSA.

The various communications issued at the time of the FCA's creation cited a "need to change" and to "reset conduct standards for the financial services industry"<sup>3</sup>. The overall aspiration is for the FCA to take a significantly more aggressive and forward looking stance. This, it is hoped, will enable it to identify and mitigate risks and issues early in order to prevent some of the widespread conduct issues that have been so damaging to the industry in the past.

### The FCA's Remit

The FCA's sole strategic objective is to "ensure that the relevant markets function well".

Supporting this there are three operational objectives, namely:

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

There is a significant degree of continuity between the FCA's remit and the conduct aspects of the FSA's role<sup>4</sup>.

<sup>2</sup> HM Treasury Consultation: A New Approach to financial regulation: judgement, focus and stability

<sup>3</sup> See The Journey to the FCA 31/10/2012

<sup>4</sup> See Appendix 1 – Statutory objectives of the FSA.

On the face of it little has changed in the two organisations' remits, however:

- The existing financial crime and market confidence objectives have been merged and strengthened by the new Integrity objective; and
- The FCA has a new duty to promote effective competition in the interest of consumers<sup>5</sup>.

It is the latter of these two changes that is the most significant. This represents a recognition that consumers do not always behave in a rational manner<sup>6</sup> and that relying on market forces to drive optimal outcomes is not always effective. A number of thematic and policy initiatives are in progress or are being launched in recognition of this fundamental shift in remit.

It is worth noting the OFT's review of the impacts that the new challenger banks created by LBG<sup>7</sup> and RBS<sup>8</sup> will have on strengthening competition in retail small business banking<sup>9</sup>. The broad conclusion of the review is that while the new organisations have the potential to compete effectively in their main markets (i.e. retail banking for TSB, SME Banking for W&G), they are unlikely to be of sufficient scale to apply significant competitive pressures on other market participants. Therefore it is likely that the banking sector will require further regulatory intervention before competition is functioning to the OFT and FCA's satisfaction.

**Question for firms:** How might the FCA's new competition objective affect the markets in which you operate?

<sup>5</sup> Under FSMA 2000 the performance of the FSA was assessed against a number of "Principles of Good Regulation" that recognised a need to "facilitate and not have an adverse effect on, competition"

<sup>6</sup> Or at least are entitled to behave in a way that is "rationally ignorant" when confronted with complicated financial products and with firms purporting to have customers' best interests at the heart of their businesses!

<sup>7</sup> Trustees Saving Bank (TSB)

<sup>8</sup> Williams & Glyn (W&G)

<sup>9</sup> Letter from the OFT to the Chancellor of the Exchequer of 11<sup>th</sup> September 2013.

## The FCA's supervisory framework & approach

Like the FSA before it, the FCA is basing its approach to supervision around three key areas:

- Firm specific routine supervision, based around regular dialogue with individual firms plus periodic "deep dives" into specific areas of perceived risk. The frequency and intensity of this dialogue is dictated by the FCA's assessment of the risk presented by the firm. The FCA's approach to routine supervision is set out in detail in Appendix 2 – The FCA's Supervisory Framework
- Review of management information, including (but not exclusive to) regulatory returns, public disclosures, complaints data and market data sources. This review is primarily to ensure that threshold conditions continue to be met in all cases; however, firms that appear to be outliers based on any of the metrics considered can expect greater scrutiny.
- Thematic work to investigate current or emerging risks across a number of firms within a sector or market. Thematic work can focus on both discovering what is going on and on looking at ways to tackle it. Thematic work is also referred to as issues and products' work or 'cross-firm' work.

Rather than any change in its overall approach, the FCA is attempting to drive change in the financial services industry by altering the tone of its dialogue with firms. This means that it is:

- Asking tougher and more probing questions about the risk that firms present to its objectives;
- Seeking to identify risks sooner and intervene earlier to mitigate them;
- Tolerating lower levels of risk;
- Increasing senior management focus on conduct risk; and
- Encouraging its staff to make bold and firm decisions.

Supporting this approach are a number of new powers that enable the FCA to act swiftly and decisively where it identifies risks to its objectives. Key amongst these are:

- The power to ban misleading financial promotions;

- The power to ban specific products or product features (without consultation); and
- The power to make public the commencement of enforcement actions (i.e. by making public warning notices).

The FCA accepts that to make decisions earlier in the process it will need to be more judgmental and make decisions not necessarily supported by clear-cut evidence. This will result in sub-optimal decisions in some cases and there will be some “collateral damage” to firms. Nonetheless, it is very clear that the FCA considers this an acceptable cost if it enables it to act decisively to achieve its strategic objectives.

## FCA activity since inception

A glance at the FCA’s website demonstrates a significant programme of activity in line with its approach and remit. Non-exhaustive lists of the FCA’s key activities are presented in appendices 3-5:

- Appendix 3 – FCA Thematic Work & Market Studies on Conduct Related Issues;
- Appendix 4 – FCA Consultations on Conduct Related Issues; and
- Appendix 5 – FCA Enforcement Actions for Conduct Related Issues

What this activity demonstrates is:

- The FCA’s continuing commitment to the FSA’s credible deterrence policy. It is clear that the FCA continues to view making examples of firms it identifies to be in breach of its requirements to be the most proportionate way of ensuring compliance in the industry as a whole.
- The FCA has an increased appetite for difficult enforcement cases, e.g. around market abuse. The approach of only taking on cases the FCA is sure to win has been consigned to history.
- The FCA’s commitment to identifying competition issues in line its increased competition remit. We anticipate that this will be a continuing theme and the FCA will maintain an enhanced focus on anti-competitive behaviour.
- Historical issues (e.g. Treating Customers Fairly, mis-selling, complaints handling, Client money etc) remain central to the FCA’s agenda.
- Policy work and rule changes (outside of the EU driven change agenda) are taking a back

seat to more aggressive implementation of the rules and guidance already in place<sup>10</sup>.

- The FCA is diligently policing the perimeter of the Regulated Activities Order and is taking swift actions against firms carrying out regulated activities without appropriate permissions.

In addition, we are aware of a number of other FCA initiatives currently underway, including:

- An initiative to streamline the authorisation process, intended particularly to encourage challenger banks;
- Investigations into ways to make it easier for consumers to switch products; and
- A line by line review of the FCA the handbook to identify and remove barriers to competition.

It should be apparent that the FCA’s activity to date is clearly supporting its revised remit and is in line with the political and statutory expectations placed on it. Although the specific areas of focus will change, we do not anticipate any significant deviation from this approach in the foreseeable future – the challenge now is for firms to adapt.

## Part 2: Firms’ Response to regulation by the FCA

The FCA’s mandate is curious, in that it is seeking to implement and enforce broadly the same requirements as the FSA, but to achieve a very different outcome. Like the TCF programme previously, this approach requires firms to define their own solutions. While this creates uncertainty, it is also an opportunity for firms to develop proportionate responses tailored to their business models. In practice, firms have responded in a range of different ways. It is critical that firms senior management are able to articulate to the FCA the changes they have made to address Conduct Risk; however, it is likely that firms’ ultimate success will be judged on the outcomes they deliver.

**Question for firms:** How well could your management team articulate the changes made to address Conduct Risk in your firm? Can they point to different outcomes resulting from the changes made?

<sup>10</sup> See Martin Wheatley’s speech of 9/12/14 to the ICI Global Trading & Market Structure Conference “Looking Ahead to 2014”

The following sections of this paper describes some of the key changes that firms have made and that constitute Avantage Reply's view of current industry best practice.

## Formalising Conduct Risk

Conduct risk brings together a number of concepts that have previously been dealt with in silos and, in many cases, treated as requirements not risks. For example:

- Firm have measured the extent to which they have achieved the FSA's Treating Customers Fairly outcomes;
- Firms have monitored compliance with various policies, for example around market abuse policies, personal account dealing etc and have tracked breaches;
- Firms have complied with the FSA's regulatory reporting requirements.
- Firms have put in place policies for Approved Persons requirements and have sought to comply with them;

What firms are now doing is revising their overall risk taxonomies to describe all the various components of conduct using risk terminology and are using formal methodologies to measure the probability and impact of failure. This has led to them strengthening their risk identification processes and enriching their risk measurement using real loss data or credible scenario analysis. In addition, firms have needed to integrate the different aspects of conducts risk in a unified governance framework to enforce a single consistent approach towards identifying, measuring and manage their overall exposure to conduct risks.

By strengthening their overall governance of Conduct Risk in this way, firms are ensuring that:

- There is a formal process in place around all aspects of managing Conduct Risk;
- Risks are identified, assessed and captured in a single central repository;
- Risk tolerances can be articulated and tracked against the overall risk appetite derived from the firm's strategic objectives;
- Appropriate controls, including policies and procedures are in place;
- Responsibility is formally assigned for tracking and managing individual risks, for the integrity of the overall process and for supporting policies and procedures;
- Appropriate forums and governance are in place;

- Risk monitoring and MI is fit for purpose and is reported in a timely fashion to the appropriate stakeholders;
- Appropriate escalation processes are in place;

In terms of Enterprise Wide Risk, most firms are choosing to call Conduct Risk out as a distinct risk category to ensure it is given sufficient prominence in risk reporting and decision making (the exception to this being for Banks' regulatory capital calculations where Conduct Risk falls under the Basel definition of Operational Risk).

**Question for firms:** How do you ensure consistent Conduct Risk MI is escalated to your firm's Risk Committee and Board?

## Defining the Control Function operating model

Closely aligned to the formalisation of Conduct Risk is the role of the various control functions (for example, Compliance, Financial Crime, Operational Risk, "Customer Fairness" functions etc) that have played a role in identifying, monitoring and managing Conduct Risk. Few firms have moved away from the traditional three lines of defence model; but as Conduct Risk has become more clearly defined, many firms have identified that the remits of different functions frequently overlap. More concerning, some firms have discovered that there are gaps in overall control function coverage and some risks have not been monitored or managed to date. As a result, firms have sought to realign, merge or redefine the roles of their control functions to drive operational efficiencies and better risk management.

A good example of why firms have needed to adopt new operating models is where they have assigned responsibility for Conduct Risk to their existing compliance functions. In some respects, Conduct Risk is a natural evolution of Compliance; however, in many cases this represented a significant broadening of the function's responsibilities, particularly where their original remit was the relatively narrow brief set out in SYSC 3.2.8<sup>11</sup> or SYSC 6.1<sup>12</sup>. Compliance functions

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<sup>11</sup> SYSC 3.2.8 requires firms carrying out designated investment business for retail or professional clients to appoint a director or senior manager to ensure that the firm complies with the rules in COBs, COLL and CASS and reports to the firm's governing body on that compliance.

placed in this situation quickly discovered that they had neither the skills nor the personnel to discharge their responsibilities and that their remit overlapped with that of other functions.

**Question for firms:** Do you control functions have the right skills, remit and resources to manage Conduct Risk throughout all parts of your firm?

## Leading the Conduct Risk agenda

Regulators have long considered the influence that Risk and Compliance issues have on a firm's decision making to be an important indicator of its overall compliance culture. Through the Treating Customers Fairly initiative and recent ARROW visits, supervisors have explicitly sought out evidence of Risk/ Compliance/ Treating Customers Fairly MI being reported at board level, being challenged and being a material factor in firms' decision making.

Firms are now taking these actions a step further by appointing heavyweight former regulators (for example Hector Sants at Barclays and Jon Pain at RBS) to senior positions to lend weight and gravitas to the conduct risk agenda. Of course, not every firm will have the need or opportunity to appoint individuals of this stature, but appointments of this type proportionate to the size and complexity of the firm can serve a number of purposes:

- They ensure that Conduct Risk issues are championed by genuinely influential individuals in the firms' senior management teams;
- They ensure that the focus on Conduct Risk is not diluted by assigning responsibility to a senior manager with other responsibilities;
- They provide a Conduct Risk perspective and robust challenge at the highest levels of firms' decision making;
- They provide strong leadership to drive Conduct Risk related change in the firm and send a clear message to staff (and tacitly to regulators) about how seriously the firm is taking the Conduct Risk challenge.

**Question for firms:** How do you ensure that Conduct Risk is recognised and given sufficient weight in discussion by your firm's Board and Executives?

<sup>12</sup> SYSC 6.1 requires firms to implement and maintain adequate policies and procedures sufficient to ensure compliance with the regulatory system and to counter the risk that the firm might be used for financial crime.

## Data driven analytics

Firms are increasingly looking to utilise data and statistical analysis to identify Conduct issues both post ante and ex-ante. Data driven analytics are an extremely powerful tool for identifying isolated or systemic conduct issues from large sets of data. The FCA is adopting increasingly advanced data driven analysis as part of its Business Model & Strategy analysis and the routine and ad-hoc data requests it makes of firms are becoming increasingly granular to support this. Examples of data driven analytics that firms are adopting include:

- Deployment of sophisticated behavioural algorithms to identify suspected frauds and criminal / terrorist financing.
- To identify potential market abuse. In the wake of the LIBOR scandal and with investigations ongoing into the manipulation of Foreign Exchange rates, firms are turning to data analysis to identify and investigate potential benchmark abuse. Indicators of LIBOR abuse might include taking trading positions highly sensitive to LIBOR movements, large off market trades, exceptions to trading policies, trades in periods where LIBOR behaves differently to proxy rates, etc. Individually, these indicators may not be particularly informative, but taken together; firms can quickly identify and investigate potential conduct issues. Similar principles apply to other forms of market abuse.
- Firms are using the proportion of non-compliant sales identified through compliance monitoring and the proportion of customers who complain about mis-sold products to extrapolate the overall cost of mis-selling and any provision that should be made (e.g. for PPI). Firms are using similar techniques to estimate numbers and potential redress costs of unidentified mis-sold products. These estimates are being used to identify areas where they need to enhance their sales processes and, in extreme cases, to target additional past business reviews.
- Firms are analysing outliers in the customer data they hold to identify higher risk sales, e.g. sales of higher risk investment products to older investors without other investment products. With firms holding increasing amounts of data and developing more sophisticated capabilities to manipulate it,

their ability to identify higher risk sales is developing rapidly.

- Firms are also analysing outliers in their own teams to identify higher risk individuals. Firms have always sought to identify and monitor high and low performers, inexperienced staff or staff achieving close to revenue/performance thresholds. The greater data analytics capability now available allows firms to develop more risk sensitive analytics, link previously separate data sources (e.g. sales and HR data) to enhance analytic capability and importantly, to use statistical techniques to validate which indicators are genuinely correlated with a higher risk of Conduct issues.
- A third area of outlier analysis is where firms examine their data to identify products or areas whose financial performance (whether measured in terms of income, profitability, return on equity or risk adjusted return on equity) is unusual – either when viewed against their history, their competitors or the remainder of the firm’s business. PPI is a good example of an issue that this type of analysis might have identified; the fact that a high proportion of Banks’ profits were derived from PPI and that this was being used to offset lower profits on the products PPI was linked to should have suggested to firms that there were potential conduct issues with PPI. This type of analytics is directly aligned with the FCA’s Business Model & Strategy Analysis, which examines in-depth the areas in which firms make their money.
- Finally, firms are starting to develop tools to link certain product types and characteristics with increased conduct risks and take ex-ante steps to address risks before they crystallise. Firms have always used intuitive expert judgement in their product governance processes for some time; what is changing here is firms’ ability to use statistical modelling and non-intuitive factors to supplement their judgement and identify and extract the drivers of past issues to identify future issues before emerge.

There are very significant opportunities for firms to enhance their management of Conduct Risk using data driven analytics. The challenge for firms is in extracting the relevant data points at an appropriate level of granularity from the various systems in which they are held. These then need to be integrated in a way that allows manipulation and data drill down. Whilst doing

this, firms need to contend with significant data quality issues from the range of legacy systems in which they are held. This is an area where we expect firms to continue to innovate and we anticipate significant advances in firms’ capabilities in this field.

**Question for firms:** What would a review of your firm’s Business Model and Strategy reveal about the conduct risks in the business? How could you use data analytics to enhance identification and management of Conduct Risks in your firm?

## Looking to the Future – the Conduct Risk Radar

Over the course of the last few years, firms have been forced onto the back foot by the barrage of conduct related issues identified by regulators and customer groups. Firms are now seeking to move out of this reactive “fire fighting” phase and take a proactive stance towards identifying, investigating and remediating potential conduct risk issues before they become part of the regulatory agenda. The encouraging aspect of this is that, in light of the FCA’s continuing “credible deterrence” agenda, firms’ senior management have a much greater appetite to mitigate risks identified ex-ante, even at the expense of short-term profits.

Firms have had “upstream risk” and horizon scanning functions in place for some time to identify regulatory changes. A number of firms are now looking at ways that they can enhance their ability to predict future challenges beyond this narrow regulatory change agenda to allow them to take ex-ante action to mitigate upstream risks.

As with any risk, there are no perfect predictive tools available; however, there are a number of steps firms are taking, firstly to improve their risk identification abilities and secondly to improve their robustness when faced with unexpected “black swan” risks. One thing that is very clear is that it is no longer sufficient to wait for the FCA to identify emerging risks on an industry wide basis. Instead, need to be able to demonstrate they have effectively analysed themselves, identified the risks they face and have taken effective remedial action to mitigate.

Firms are improving their ability to identify emerging risks by:

- Using credible scenario analysis to identify scenarios where customers or market counterparties could be directly or indirectly disadvantaged by the firm’s actions and taking

action to mitigate any conduct risks the scenarios present.

- Making staff more aware of their roles and responsibilities with regard to identifying and managing Conduct Risk and of how important this is to the firm.
- Ensuring they are aware of issues on the FCA’s radar (thematic reviews, regulatory change, action taken against other firms, etc.).
- Enhancing their use of data to identify trends and emerging risks, including analysis to replicate the FCA’s Business Models and Strategy analysis
- Enhancing control function operating models, competencies and resourcing.
- Increasing the frequency, robustness and targeting of routine risk / compliance monitoring.
- Continuing to enhance their product governance and TCF frameworks to identify emerging customer risks.
- Carrying out “stress tests” to examine how their products and services respond to different market or customer situations and the impact this would have on the product objectives.
- Making better and more explicit links between Conduct Risk identification and management and performance management / remuneration.
- Reviewing job descriptions and remuneration policies to identify where individuals’

incentives are not aligned with the firms’ Conduct Risk appetite.

- Reviewing potential conflicts of interest between groups of staff, staff and firm and firm and customers.
- Examining existing policies, MI and other risk measurement and mitigation tools to ensure that they are fit for purpose and the residual risk is well understood.
- Reviewing the firm’s practices and business models to ensure that it is aware of any markets it is involved with where completion is not acting effectively.

**Question for firms:** How does your firm ensure it identifies emerging Conduct Risks ahead of the FCA?

## Conclusions

Firms have adopted a wide range of responses toward the challenge of regulation by the FCA and it is fascinating to observe how the financial services industry as a whole continues to react. What is clear in all cases is that it is not sufficient for firms to maintain the status quo; new regulators set new challenges and require firms to adopt new approaches. Firms that fail to adapt will quickly find themselves under increased scrutiny as the FCA seeks to drive change throughout the industry.

## Appendix 1 – Statutory objectives of the FSA

**Market Confidence** - maintaining confidence in the UK financial system

**Financial Stability** – Contributing to the protection and enhancement of the stability of the UK financial system<sup>13</sup>

**Public Understanding** - Promoting public understanding of the financial system<sup>14</sup>

**Consumer Protection** - Securing the appropriate degree of protection for consumers

**The reduction of Financial Crime** - Reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime

## Appendix 2 – The FCA’s Supervisory Framework

The FCA is the conduct supervisor for approximately 26,000<sup>15</sup> and the prudential supervisor for approximately 23, 000 firms. Its supervisory approach is based on three key pillars of work to tackle Conduct Risk issues, plus an additional pillar of work to tackle Prudential Risks. These pillars are set out in the table below:

Pillar	Description
Pillar 1. Proactive Firm Supervision (Firm Systemic Framework)	Assess whether firms are run in line with the FCA’s objectives via firm specific assessments and to identify and mitigate drivers of poor conduct. Characterised by the question “does the firm have the interests of its customers and the integrity of the market at the heart of how the business is run”?
Pillar 2. Event-driven work	Event driven supervision is reactive work driven by emerging or unforeseen issues. The FCA response to these issues is expected to be swift as it seeks to avoid the large scale issues of the past.
Pillar 3. Issues and Products	Otherwise known as thematic supervision, this will consist of deep dives into samples of firms to investigate key issues identified through sector specific risks assessments. Findings and remedial actions will typically be applied to all firms in a given sector, with firms involved in the thematic review sample frequently facing enforcement action if their practices are deemed to be sub-standard.
Prudential Regulation	Focus is on minimising the impact of firm failure on consumers. Pro-active prudential supervision is limited to a small number of firms.

<sup>13</sup> Added to the FSA’s remit by the Financial Services Act 2010

<sup>14</sup> Removed from the FSA’s remit by the Financial Services Act 2010

<sup>15</sup> Source FCA website

## Pillar 1 - Proactive Firm Supervision (Routine Supervision)

The FCA has divided firms into four groups for Conduct Risk. This assessment is based on the FCA's assessment of each firm's potential impact on the FCA's objectives and on the number of retail customers

The Pillar 1 supervisory approach for each group of firms is set out in the table below

Category	FCA relationship	Supervisory cycle	Nature of supervision	FCA feedback
C1	Dedicated Firm Specific Supervisor	1 year	Business Model & Strategy Analysis (BMSA) to identify key conduct risks <sup>16</sup> .  Proactive engagement with Senior management, review of MI and analysis of emerging risks  Typically two deep dive reviews per year	Annual letter setting out FCA view of the firm and the risks it poses to the statutory objectives  Annual supervision programme  Annual Risk Mitigation Plan
C2	Dedicated Firm Specific Supervisor	2 year	Business Model & Strategy Analysis to identify key conduct risks  Proactive engagement with Senior management, review of MI and analysis of emerging risks  Typically one deep dive review per year	Biannual letter setting out FCA view of the firm and the risks it poses to the statutory objectives  Biannual supervision programme  Biannual Risk Mitigation Plan
C3	Sector specific supervisors	4 year	Business model analysis will focus on identifying outliers  Review of how firm's businesses are run and controlled  Interim reviews for firms subject to significant change	Risk Mitigation Plan in line with supervisory cycle
C4	Sector specific supervisors	4 year	Touch point once per cycle to assess how each firm's business is run.  Can be via road shows, telephone calls, online assessments, interviews or a combination of the above	By exception where firms are deemed to present a higher risk to the FCA's objectives

In addition, the FCA divides those firms for which it is the Prudential Regulator into a further four categories (which are independent of the firm's conduct categorisation). This assessment is primarily based on the information in firms' regulatory returns, although additional data may be sought where regulatory returns do not provide a full picture of a firm's activities or market impacts.

<sup>16</sup> See COND 2.7 for the FCA's definition of a firm's business model

The Prudential classification and supervisory approach for each group is set out in the table below

Category	Definition	Nature of supervision
P1	Prudentially critical firms whose disorderly failure would have a significant impact on the market in which they operate (e.g. where a market is highly concentrated and a disorderly failure of one participant could not easily be assimilated by others and/or firms with significant client money or asset holdings)	Periodic assessment of capital and liquidity (if applicable) Focused Prudential reviews as and when required Any feedback included in Risk Mitigation plans
P2	Prudentially significant firms whose disorderly failure would have a significant impact on the market in which they operate, but where client assets/money holding are less significant or an orderly wind-down can be achieved	Periodic assessment of capital and liquidity (if applicable) Focused Prudential reviews as and when required Any feedback included in Risk Mitigation plan
P3	Prudentially insignificant firms whose disorderly failure is unlikely to have a significant impact	Reliance on firms' data (i.e. regulatory returns) and alerts resulting from inconsistencies or threshold breaches Potential inclusion in peer group reviews
P4	Firms whose specific circumstances require a bespoke approach (e.g. firms in administration or with special supervisory regimes)	Firm specific

### Pillar 2 & Pillar 3 – Event Driven Work and Issues and Products Reviews (thematic work)

Firms from any conduct category can be asked to participate in thematic work at any time.

### Appendix 3 – FCA Thematic Work & Market Studies on conduct related issues

Since the FCA's inception we have seen a number of thematic reviews proposed, launched, in flight or coming the fruition. The (non-exhaustive) list below sets out some of the key reviews to date (the assignment of a "TR" reference indicates that a report or interim report has been published by the FCA):

- Price Comparison Websites
- TR 13/10 - Outsourcing in the Asset Management Industry
- TR 13/9 Anti-Money Laundering & Anti-Bribery and Corruption Systems and Controls: Asset Management Firms
- Anti-Money Laundering & Anti-Bribery and Corruption Systems and Controls: Smaller Banks
- Anti-Money Laundering & Anti-Bribery and Corruption Systems and Controls: Smaller Commercial Insurance Brokers
- TR 13/8 The governance of unit-linked funds
- TR 13/7 Payment protection insurance complaints: report on the fairness of medium-sized firms' decisions and redress
- TR 13/6 Mobile banking and payments
- TR 13/5 Supervising retail investment advice: how firms are implementing the RDR
- TR 13/4 Automatic renewal of fixed-term bonds
- TR 13/3 Banks' control of financial crime risks in trade finance
- TR 13/2 Mobile phone insurance – ensuring a fair deal for consumers
- TR 13/1 Motor Legal Expenses Insurance thematic project

- Market Study into SME Banking (conducted jointly with the OFT)
- Cash Savings Market Study
- Retirement products case study
- Wholesale Strategic Review
- Market Study into Add-on Insurance products

## Appendix 4 – FCA Consultations on Conduct related Issues

The list below highlights what we consider to be the key FCA consultations from a Conduct Risk perspective (GC represents a guidance consultation, FG represents finalised guidance, and CP represents a consultation on the FCA rules):

- GC13/7 Changing customers to post-RDR unit classes
- GC13/5 Supervising retail investment advice: inducements and conflicts of interest
- GC13/3 Examples of good and poor practice in Banks' control of financial crime risks in trade finance
- GC13/2 Dealing Fairly with interest-only mortgage customers who risk being unable to repay their loan
- GC13/1 Proposed guidance on oversight of member controls carried out by recognised investment exchanges and multi lateral trading facilities (see also FG13/6)
- CP 13/17 Use of Dealing Commission
- CP 13/16 Competition in the market for services provided by a recognised investment exchange: proposed amendments to REC
- CP13/13 The FCA's regulatory approach to crowd funding (and similar activities)
- CP13/12 CRDIV for investment firms
- CP13/10 Detailed proposals for the FCA regime for consumer credit
- CP13/5 Review of the client assets regime for investment business
- CP13/4 Distribution of retail investments: referrals to discretionary investment managers and adviser complaints reporting
- CP13/2 Mortgage Market Review – Data reporting
- FG13/8 A guide for self-invested personal pensions operators
- FG13/7 Dealing fairly with interest only mortgage customers who risk being unable to repay their loan
- FG13/6 Market operators' oversight of member firm compliance with rules

## Appendix 5 – FCA enforcement actions for Conduct related Issues

The list below highlights what we consider to be the key topics that the FCA has taken enforcement action over from a Conduct Risk perspective:

- Market Abuse
- Insider Dealing
- LIBOR Manipulation
- Incorrect Transaction Reporting
- Trading book risk control failings
- Transaction Management Failings
- Mis-selling of Interest Rate Swaps<sup>17</sup>
- Mis-selling of complex investment products
- Unsuitable sales of investment products
- Insufficient evidence of suitability for Wealth Management clients
- Mis-selling of add-on insurance policies
- Misrepresentation of investment products
- Complaints handling failings
- Failures to safeguard client money and assets

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<sup>17</sup> This is not technically an enforcement action but an agreed action by the banks

- Inadequate AML controls
- Unfair treatment of mortgage customers where the firm had miscalculated payments
- Promotion of unauthorised Collective Investment Schemes
- Illegal land banks and other unauthorised investment schemes
- Unauthorised and / or clone firms
- Conflicts of Interest
- Fraud
- Boiler room scams
- Unfair / anti-competitive inducements