Financial Services Regulatory Insights

FCA sets out wholesale banking supervisory strategy

AT A GLANCE

September 2023

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What's new?

- The FCA issued a Dear CEO letter to all wholesale banks active in the UK on 8 September 2023, setting out its view of risks in the sector and supervisory work plan for the next two years.
- The FCA identifies the recent market stress and external market environment as continuing to frame its supervision of the sector. In particular, the regulator calls out banks' risk management, control frameworks, operational resilience, and organisational changes as priorities for its supervision.
- Banks should also expect supervisory attention across a range of other topics, including ESG commitments, Artificial Intelligence (AI), Consumer Duty implementation, diversity, equity and inclusion, and approach to non-financial misconduct.

What does this mean?

- The FCA recognises the continued challenges that the current market environment poses to wholesale banks. In particular, the regulator highlights the importance of firms' ability to manage a range of risk factors, noting that operational and reputational risk failures can quickly accelerate into broader concerns about a firm's safety and soundness.
- The FCA notes concerns over weaknesses in **risk management capabilities**, in particular poor management and knowledge of clients' business profiles.
- The FCA notes issues with firms' underappreciation and understanding of client concentration within and across firms and markets, and expects firms' stress assumptions to have been updated in light of recent market events. These stress assumptions should capture the impact on the broader financial system, including services provided by third parties.
- Banks' boards and senior management will be asked, as part of its supervisory engagement, to evidence how improvements have been made to risk management and oversight across the business, and how this is underpinned by a strong culture. The FCA will carry out supervisory testing on firms' embeddedness of risk management capabilities.
- The FCA also raises concerns that banks' ability to manage **conduct risks** has been diminished due to a lack of investment in control frameworks. It plans to monitor firms' behaviours in this area and reiterates the importance of boards and senior management prioritising the issue.
- The regulator also notes a continued blurring of first and second line responsibilities, for example, in who is responsible for delivering against a firm's public ESG commitments.
- The FCA will accelerate its testing programme to assess firms' control frameworks, including through more in-person supervisory visits. Firms' conflict of interest management will be a particular area of focus.
- Banks' **operational resilience** will continue to draw supervisory focus, in particular firms' understanding of dependence on third parties and the impact and mitigation of any loss in service.

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- The FCA reiterates the need for firms' prompt notification if they, or a third party, is subject to a cyber attack, and expects firms to have taken lessons from recent operational resilience events even if not directly impacted by them.
- Regarding **operational changes**, the FCA reiterates that UK management need to demonstrate understanding of their booking model and have appropriate oversight and controls in place. If a firm is considering any changes to how they serve clients, location, booking model, or risk management arrangements, the FCA expects to be promptly notified.
- On **Consumer Duty**, the FCA will test the robustness of firms' assessments and implementation of the rules. It expects firms to be able to monitor how any changes to their arrangements may impact their compliance with the Duty.
- The FCA will also focus on how firms can demonstrate their financing activities are aligned to their own **net zero transition plans**, and that product and public facing ESG commitments are delivered in practice, including ensuring there is clarity in responsibilities between the first and second lines of defence.
- Banks should also expect regulatory engagement on their current and future **deployment of AI** and associated control infrastructure. In addition, the FCA plans to engage with banks to understand their role in furthering meaningful change on **diversity, equity and inclusion** in the sector.
- The FCA highlights the severity of **non-financial misconduct** and reiterates the need for firms to have effective systems in place to identify and mitigate risks.
- The FCA will assess reports of non-financial misconduct received and will consider carrying out work to assess the effectiveness of firms' controls.

What do firms need to do?

- The FCA's letter reflects a broad supervisory agenda and suggests an increased scrutiny of firms, with a clear focus on risk management and controls, particularly given recent market events.
- The FCA expects CEOs to have discussed the letter with other Directors and/or boards within two months. The FCA is likely to expect firms to feedback to supervisory teams what they will be doing in response to the letter.
- The breadth of the priorities reflects the risk environment that wholesale banks are operating in. Banks need to have a clear focus on risk management and controls, to address a wide range of risks, including conduct risk. Investment in technology and data analytics to support horizon scanning and identification of key risks will enhance this.
- Banks should expect to receive further information requests from the FCA, particularly focused on controls frameworks and conflicts of interest management and for further multi-firm or thematic reviews.
- Firms operating in multiple jurisdictions and which are considering their long-term operating model should be alert to the FCA and PRA's expectations regarding their UK activities (including on booking models), and be able to clearly demonstrate how risks are overseen and managed.
- Firms should also be mindful of the scale and pace of regulatory reform ongoing in the UK and be prepared to meet the operational and compliance challenges this presents.

Next steps

Firms' boards should have discussed the contents of the letter and agreed any actions and/or next steps within two months of the letter being issued.

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